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PUERTO RICO'S POLITICAL STATUS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 712

NOVEMBER 14 AND 15, 1989

(Part 1 of 2)

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PUERTO RICO'S POLITICAL STATUS

TUESDAY, NOVEMBER 14, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:14 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Bradley, Mitchell, Pryor, and Packwood.

[The press release announcing the hearing follows:]

[Press Release No. H-53, November 9, 1989]

SENATOR BENTSEN ANNOUNCES HEARINGS ON PUERTO RICO'S POLITICAL STATUS; VOTERS WOULD CHOOSE STATEHOOD, INDEPENDENCE OR COMMONWEALTH STATUS

WASHINGTON, DC.—Senator Lloyd Bentsen (D., Texas), Chairman, announced Thursday that the Finance Committee will hold hearings next week on legislation allowing Puerto Rico to hold a referendum on its political status.

The hearings on the bill, S. 712, are scheduled for Tuesday, November 14 and Wednesday, November 15 at 10 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"The residents of Puerto Rico face a choice of monumental importance both to them and to all the other citizens of this Nation," Bentsen said.

"The Finance Committee faces a significant challenge to assure that the tax, social welfare, and tariff provisions of this bill serve the best interests of Puerto Rico and the United States from the standpoint of Puerto Rico's economy, the federal budget, and the need to provide a fair and even-handed basis for the proposed referendum," Bentsen said.

S. 712 provides for a referendum in Puerto Rico in 1991 to let residents there choose between statehood, independence, or continued commonwealth status. The bill, as referred to the Finance Committee, is designed to be self-executing so that whichever option a majority of the electorate selects would then will go into effect without the need for further congressional approval.

Accordingly, the bill includes provisions which make the major changes in federal laws applicable to Puerto Rico that would be necessary to implement each of the three options. This involves many provisions within the Finance Committee's legislative jurisdiction—internal revenue taxation, international trade, and the various social welfare programs established by the Social Security Act.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will get underway.

Secretary Gideon and Ms. Peterson, if you would, please come forward.

The CHAIRMAN. Today the Finance Committee begins 2 days of hearings on S. 712, the Puerto Rico Status Referendum Act. This legislation is of monumental importance for the people of Puerto Rico and for all the citizens of the United States. The bill also raises some extremely complex issues, and we will be exercising a lot of care as we consider it.

We need to make sure the provisions of this bill serve the best interests of the people of Puerto Rico and the best interests of the United States from the standpoint of Puerto Rico's economy, the Federal budget, and the need to provide a fair and evenhanded basis for the proposed referendum that would result from passage of this legislation.

The Senate Energy and Natural Resources Committee, which has primary jurisdiction over issues relating to Territorial Possessions of the United States, reported out S. 712 on August 2. The bill has now been referred to the Finance Committee because many of its provisions fall within the jurisdiction of this committee—taxes, trade, social welfare. We are going to look at those issues under our jurisdiction and make any appropriate revisions.

S. 712 is intended to enable the people of Puerto Rico to exercise the right of self-determination, through a binding referendum on the future status of the Commonwealth.

Under the referendum, Puerto Rico residents would be able to vote for one of three options: statehood, independence, or continued commonwealth status. If any of these three options receives a majority vote, that option would be implemented in accordance with the provisions of this legislation.

Under the provisions of the bill in its current form, no further congressional action would be needed. That is a very material point and one, obviously, that has to be given further consideration.

Questions are raised by each of the three options. We will begin today by considering the tax aspects involved. We will also consider some of the constitutional issues that have been raised about the referendum process. Tomorrow's hearings will focus on spending programs and trade issues. We will be hearing from representatives of each of the three major parties in Puerto Rico and from representatives of the Administration.

I look forward to what I think will be a provocative and a very open discussion of the three different options facing the people of Puerto Rico and, in turn, facing the people of the United States.

I defer to the Ranking Minority Member, Senator Packwood, for any comment he might want to make.

Senator **PACKWOOD**. Mr. Chairman, we have a lot of witnesses, and I will defer my statement.

The **CHAIRMAN**. All right.

Mr. Secretary, if you have a statement, we will be pleased to receive it.

STATEMENT OF HON. KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Secretary **GIDEON**. Thank you, Mr. Chairman, and Senator Packwood. It is a pleasure to be here today on behalf of the Administration to discuss Senate Bill 712, which as you have noted is a bill to provide a referendum for the political status of Puerto Rico.

This bill would give the people of Puerto Rico an historic opportunity to vote upon the status of that island. The bill would provide for a referendum, to be held in 1991, in which the Puerto Rican people could decide among the options of statehood, independence, or commonwealth.

The Administration strongly supports the right of the people of Puerto Rico to decide for themselves the status of the island. Further, as the President has noted a number of times, he favors the admission of Puerto Rico into the Union as a State, thereby assuring the people of Puerto Rico an equal standing with other United States citizens.

By providing for a status referendum, the United States Government would be assisting the Puerto Rican people to exercise the basic political right to determine the nature of their government.

As I indicated in testimony before the Committee on Energy and Natural Resources earlier this year, the Administration firmly believes that the Puerto Rican people should be given an opportunity to express their will in a manner that recognizes the historic and fundamentally political nature of their decision of self-determination. The importance of the decision they face as a people transcends narrow concerns about specific aspects of economic or fiscal structure.

The Administration recognizes, however, the difficulty of isolating the impact of tax and financial issues from the question of Puerto Rico's future status. We also recognize the desire of the Puerto Rican people to have a referendum which is self-executing in its important features. This desire was eloquently and unanimously expressed by representatives of the various Puerto Rican political parties who testified before the Committee on Energy and Natural Resources earlier this year. We therefore accept the proposition that the important economic features of each option must be identified in order to allow the voters to have an informed choice.

In view of these competing considerations, the Administration today endorses Senate Bill 712 currently before your committee. We believe that the bill strikes an appropriate balance between two important goals. First, it informs the Puerto Rican people of the broad outline of the fiscal and economic structures applicable to each of the three status options. Yet it preserves this essentially political choice free from a welter of details, transitional rules, and administrative provisions that we think are best addressed after the political choice is made.

We believe that the substance of the proposed tax and economic results under each of the three options in Senate Bill 712 represents a reasonable resolution of the difficult policy choices faced by the drafters of this legislation. In particular, with respect to the statehood option, we support the decision to defer until January 1, 1994, the application of Federal tax laws other than those relating to excise taxes. This provision will give both the United States and Puerto Rican tax authorities the necessary time to ensure a smooth transition from one system to the other. In addition, we believe that this deferral will assist in the process of developing detailed transitional rules for Congress to consider enacting before the January 1, 1994 changeover.

We believe that the proposed phase-out under the statehood option of the section 936 credit during the period from 1994 through 1997 reflects a sensible approach to minimizing the economic dislocation that could result from an abrupt change in status. The future of section 936 is of course a significant concern to the Puerto Rican people, and how it should be treated under this bill presents a difficult question for Congress. We believe that the consideration given to this issue by the Committee on Energy and Natural Resources earlier this year has produced a good and defensible balance among the different interests at stake.

It is not, however, the only alternative that might have been adopted. In particular, a uniform phase-out of section 936 under both the statehood and commonwealth options would eliminate what is perceived by many as a bias in the bill toward commonwealth. Nevertheless, we recognize that section 936 cannot be viewed in isolation from the other costs and benefits affected by the referendum, and we seek an opportunity for the Puerto Rican people to make a fundamental decision about their political future, not a straw poll on relative tax benefits. We particularly appreciate the difficulties presented in making each option fairly equivalent. Accordingly, the Administration will accept the treatment of section 936 proposed in the current bill and the related congressional judgment that the economic provisions set forth for the three alternatives are fairly equivalent.

With respect to the proposed cover-over of certain tax revenues to the Treasury of Puerto Rico under the statehood option, the Administration has certain concerns, which are discussed in more detail in my written testimony. In general, however, we stand ready to cooperate with this committee in developing workable mechanisms for ensuring that the cover-over approach to statehood grants can be smoothly implemented.

In each of the areas I have just mentioned, we anticipate that future and further legislation by Congress may be necessary after the referendum to cover particular details of the transition. In a separate attachment to my written statement, I have highlighted some of the issues that I think such legislation might have to cover. By mentioning these issues, however, I do not suggest that they be addressed in this bill. As previously indicated, the Administration's view is that such relatively technical details would be most appropriately worked out after the Puerto Rican people have had an opportunity to express their political choice.

The Administration also endorses, subject to some technical comments which I shall discuss presently, the bill's approach to fiscal matters under the independence and commonwealth options.

Each of the political options covered by the bill—statehood, independence, and commonwealth—raises special issues that affect the tax systems of both Puerto Rico and the United States. We believe that the bill should clearly define the basic tax structure under each of the status options. However, we also believe that the fundamental political choice of the future of Puerto Rico should be completed prior to congressional development of technical transitional rules for any new tax system. In general, the level of detail in the current bill acceptably balances these objectives. The remainder of my testimony, therefore, will identify the tax results of the bill's provisions as drafted, note some ambiguities remaining, and highlight issues which the bill's tax provisions do not currently address.

Revenue estimates and projections for each of the tax provisions of S. 712 are attached to my written statement. It is difficult to present very precise estimates of the Federal revenue consequences of the various options described in the bill, but it may be helpful for purposes of this discussion to consider some of the rough guidelines that we have offered for you today.

With respect to the section 936 phase-out, both the independence and statehood options assume some form of reduction of the tax incentives currently provided under the Internal Revenue Code in section 936. While no change to section 936 is currently contemplated under the commonwealth option, we expect that Congress would continue to review and revise section 936 and other tax benefits as necessary should that option be the one selected.

We estimate that in fiscal year 1989 the tax benefits received by section 936 corporations amount to approximately $1.9 billion, and that a phase-out of section 936 would yield a net reduction of approximately 25 percent of income subject to United States tax. A phase-out of section 936 benefits would probably cause some economic dislocation in Puerto Rico, at least in the short run. Employment in section 936 companies now accounts for about 12 percent of total Puerto Rican employment; however, it is very difficult to project the extent to which Federal tax collections would be affected by any such dislocation. Under the statehood option, collections of personal income tax may be somewhat reduced for a time, but fully phased-in Federal personal income tax collections from Puerto Rico can be expected to be relatively modest.

The statehood option also presents the issue of how a newly-imposed Federal income tax will interact with a Puerto Rican State tax system. The effects of this change must be considered for both individual and business tax revenues.

The extension of Federal income tax to individuals in Puerto Rico would perhaps raise some $500 million per year at 1989 levels net of all earned income tax credits. In comparison, the Puerto Rican government collected about $900 million in personal income taxes in its fiscal year ending June 30, 1989, or about 30 percent of total Puerto Rican revenue from all sources. This amounted to only about 5 percent of personal income in Puerto Rico.

As a State, we think Puerto Rico could design a tax system which would maintain combined revenue levels. In the business taxation area, similar efforts would need to be made.

Under the independence option, the elimination of section 936 would increase Federal tax collections, if 936 corporations remained in Puerto Rico as U.S. corporations, or if they moved back to the United States. However, some Puerto Rico-oriented companies in routine industries such as apparel may choose to reincorporate as Puerto Rican companies. This also could affect the revenues.

Mr. Chairman, I have a number of specific comments, but I know you are very tight on time this morning. I would simply ask that the balance of my written statement be entered in the record.

The **Chairman**. Mr. Secretary, that will be done. If you have any other summary comments you would like to make, we can give you additional time.

Secretary **Gideon**. Let me note a couple of comments, if I may, Mr. Chairman.

Specifically, on the uniformity clause issue you are going to hear about this morning, we recognize that any continuation of 936 after statehood would have to be tested under the uniformity clause of the United States Constitution, which broadly requires that taxes be uniform throughout the United States. We defer to the Justice Department's views on this issue, and you will shortly hear from Ms. Peterson.

We would encourage, as I understand Ms. Peterson will this morning, fact-findings by the Congress to support a congressional determination that providing that transitional tax benefits to Puerto Rico is appropriate, and that any section 936 transition is well suited to achievement of those congressional goals.

I might also note that we view the decision with respect to the repeal of section 936 under the independence option as important because of its effect on tax sparing in treaties. Let me also note that we have concerns about some of the administrative provisions, particularly as they affect the tax laws that are proposed for a commonwealth. Those are all set forth in more detail in my statement.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Gideon appears in the appendix.]

The CHAIRMAN. Ms. Peterson?

STATEMENT OF SHIRLEY D. PETERSON, ASSISTANT ATTORNEY GENERAL, TAX DIVISION, U.S. DEPARTMENT OF JUSTICE

Ms. PETERSON. Mr. Chairman, Senator Packwood:

It is an honor to appear before you today on behalf of the Department of Justice to discuss Senate Bill 712, a bill "To Provide for a Referendum on the Political Status of Puerto Rico." As the Assistant Secretary of the Treasury for Tax Policy has just testified, the Administration strongly supports this bill, which would permit the people of Puerto Rico to determine the future political status of their island.

I am here today to testify as to the constitutionality of the economic adjustment provisions in the statehood portion of the bill. We believe that those provisions would meet the requirements of the Constitution and would likely be upheld by the courts. As I will discuss shortly, however, the ultimate resolution of that question hinges, in part, on congressional findings regarding the type and magnitude of economic dislocation that would be occasioned by Puerto Rico's transition into statehood.

My testimony will focus primarily on two provisions in the statehood portion of the bill: first, the provision in section 213(d) of the bill, which would phase out the section 936 tax credit; and second, the provision in section 213(e) of the bill, which would provide for the covering over of certain Federal tax revenues into the Puerto Rican Treasury.

The Justice Department has other technical, legal, and constitutional concerns with certain provisions of S. 712 that will be presented later.

I will turn now, first, and discuss the phase-out of the section 936 benefits.

As you know, Section 936 of the Internal Revenue Code effectively exempts from U.S. taxation certain income attributable to Puerto Rican business and investments. Under section 213(d) of the bill, the Federal internal revenue laws would apply to Puerto Rico effective January 1, 1994, if it became a State. As a proviso to that effective date, the section 936 credit would be phased out ratably over 4 years. Under the bill, then, the section 936 credit would be continued for approximately 6 years after Puerto Rico became a State: the current credit would remain fully intact from the date of statehood proclamation through 1993; and the credit would apply as specified by the phase-out provision from 1994 through 1997.

The proposed extension of section 936 benefits to Puerto Rico after it becomes a State raises a constitutional question under the Tax Uniformity Clause. Article I, Section 8, Clause 1 of the Constitution provides that "The Congress shall have the Power To lay and collect Taxes, Duties, Imposts and Excises to pay the debts and provide for the common Defense and general Welfare of the United States, but all Duties, Imposts and Excises shall be uniform throughout the United States."

The Tax Uniformity Clause was one of several measures introduced at the Constitutional Convention to limit the National Government's authority to wield its power over commerce and taxation to the disadvantage of particular States. As stated by Justice Story in his "Commentaries on the Constitution of the United States," the purpose of the Tax Uniformity Clause was "to cut off all undue preferences of one State over another in the regulation of subjects affecting their common interests" and to prevent "oppressive" combinations of States from exercising their taxing powers to strike at the "vital interests" of one region.

It seems to us that the exercise of the taxing power by a Congress composed of representatives of 50 States to grant temporary tax benefits to the 51st State entering the Union hardly qualifies as the oppression which the Tax Uniformity Clause was designed to prevent. Indeed, there is no evidence that the Framers intended the Uniformity Clause to so constrain the exercise of Congress' power under Article IV to admit new States to the Union as to disable Congress from fashioning reasonable and necessary transitional measures.

We believe that the proposed phase-out of the section 936 credit would not create an "undue preference" for Puerto Rico and would not be found to violate the Tax Uniformity Clause. We would have serious constitutional reservations, however, if the section 936 benefits were instead extended indefinitely.

The courts have not dealt extensively with the various uniformity clauses in the Constitution, and the precise boundaries of congressional authority are not clearly defined. However, there have been two recent cases thoroughly considering the uniformity provisions of the Constitution. Those cases are *United States* vs. *Ptasynski,* and the *Regional Rail Reorganization Cases.*

In those cases, the Supreme Court held that classifications framed in geographical terms could, in certain circumstances, survive challenge under the uniformity clauses. Thus, in *Ptasynski,* the Court found constitutional a statutory exclusion from the Crude Oil Windfall Profits Tax of 1980 of oil drawn from a geographically defined area that included portions of Alaska. The Court held that Congress could frame tax legislation in geographic terms in response to a geographically isolated problem. It concluded that Congress had not sought to benefit Alaska for reasons "that would offend the purpose of the Clause," such as "intend[ing] to grant Alaska an undue preference at the expense of other oil-producing States."

Equally, in the *Regional Rail Reorganization Cases,* the Supreme Court considered a challenge to the Rail Reorganization Act of 1973, on the ground that it violated the bankruptcy uniformity requirement, because it operated only in a single statutorily defined region. Although the Court acknowledged that "the argument has certain surface appeal," it concluded that it "is without merit because it overlooks the flexibility inherent in the constitutional provision." As the Court observed, "[t]he uniformity provision does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems."

The Supreme Court's recent decisions provide a basis for Congress to consider Puerto Rico's unique circumstances when structuring tax legislation. We believe that the retention of the section 936 preference as a transitional measure could, if supported by adequate congressional findings, be justified as taking into account localized problems unique to Puerto Rico—particularly, the economic dislocation that would result to an already economically depressed state from a sudden and immediate termination of the section 936 benefits.

We believe that it is within Congress's powers under Article IV of the Constitution, concerning both the admission of new States to the Union and the governance of United States territories, to ameliorate the economic dislocation occasioned by Puerto Rico's admission into the Union.

Retention of the pre-existing tax benefits for a limited transitional period narrowly tailored to the goal of avoiding severe economic dislocation in Puerto Rico should, in our view, satisfy the requirements of the Tax Uniformity Clause. As stated by the Supreme Court in the *Regional Rail Reorganization Cases,* in discussing the analogous Bankruptcy Uniformity Clause, "the uniformity clause was not intended to 'hobble Congress by forcing it into nationwide enactments to deal with conditions calling for remedy only in certain regions.' "

In light of the uniformity provisions, however, section 213(d) must represent a direct, tailored response to a geographically isolated problem; namely, the economic dislocation that would otherwise occur upon Puerto Rico's admission to the Union.

In his testimony, the Assistant Secretary noted that the 936 credit accounts for 12 percent of the total Puerto Rican employment, and the report of the Energy and Natural Resources Committee points out that the unemployment rate in Puerto Rico for 1988 was 15.9 percent, or approximately three times that of the United States.

We believe that additional congressional findings concerning the magnitude of this economic dislocation would be helpful. The legislative history of S. 712 should demonstrate that each special provision addresses a particular problem in Puerto Rico. We concur with the views of the Assistant Secretary and join him in encouraging further fact-finding to support a determination that the limited extension of section 936 benefits is designed to address a geographically-isolated problem.

I will turn now to discuss section 213(e), the State grants and assistance provision. As you know, section 213(e) of the bill would provide for several so-called "cover-over" mechanisms. Under this section, revenues derived from certain Federal taxes collected in Puerto Rico would be remitted into the Puerto Rican Treasury:

First, the cover-over of the rum excise tax would be continued after statehood; and, second, the revenues collected in Puerto Rico from any new Federal excise tax would be covered over.

The bill provides that, "[a]s a compact with the State of Puerto Rico," no alterations would be made in these cover-over provisions until after October 1, 1998.

The covering-over provisions have been in existence since about 1917, and they are contained in section 7652 of the code. They constitute an indefinite appropriation, arising out of Congress's powers under the General Welfare Clause.

The Supreme Court has held that Congress's powers "to provide for * * * the general Welfare" are quite expansive. I have some quotes from the Supreme Court; but, given that time is passing, suffice it to say that in light of the Supreme Court's construction of the General Welfare Clause, as well as Congress's authority to admit new States to the Union, we believe that it is highly unlikely that the "cover-over" provisions would be held unconstitutional. Indeed, the cover-overs might properly be viewed as merely replacing funds that would otherwise have to be appropriated to deal with Puerto Rico's economic problems.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Peterson appears in the appendix.]

The CHAIRMAN. Thank you very much, Ms. Peterson.

I note that this legislation has three guiding principles: first, that there be a level playing field among the three options and the three parties; second, that there be a smooth transition to the option finally chosen; and, third, that it be revenue neutral, to the extent possible.

Does the Administration agree with the statement of principles? Are there others the Administration would like to add, or some the Administration would like to change?

Secretary GIDEON. In general, we endorse those principles, Mr. Chairman. I think, on revenue neutrality, that achieving a precise balance may be difficult, as the committee that previously considered this found. I think, however, they have done an admirable job. It is clear that their alternative will, over a period of time, will achieve revenue neutrality.

The CHAIRMAN. I am sure the three leaders of the three parties aren't going to agree on providing a level playing field among the three options; each of them hopes that this particular option will have the advantage, to help sell his particular point of view.

I would also believe that, among the three options the question of whether the playing field is level or not is going to be in the eye of the beholder. Achieving a perfectly level playing field on these issues is a very difficult thing to accomplish.

Secretary GIDEON. I think it is a Solomonic judgment that you are called on to make. Indeed, the reason we are endorsing the judgment that was made is that we thought, given the competing considerations, this was a fair formulation. As I noted, there could be disagreements with it, obviously depending on your point of view. I think that any one of the supporters would like the option to be better for his particular option. But in reviewing this bill in general, we think that this is a fair balancing of the three options.

The CHAIRMAN. Well, let us look at that. If Puerto Rico chooses statehood, section 936 is phased out over a period of time. If Puerto Rico remains a commonwealth, section 936 stays. Is that correct?

Secretary GIDEON. Yes, although——

The CHAIRMAN. If they choose independence, section 936 would be eliminated immediately, wouldn't it?

Secretary GIDEON. That is correct. There would be real treaty problems if you didn't take it out immediately. But there are a number of grants in the independence option. In other words, I think that the committee attempted to balance the effects of all three options, given the constraints.

The CHAIRMAN. You don't think that bill creates a bias by retaining section 936, doesn't that make commonwealth status more desirable?

Secretary GIDEON. I guess from a tax policy standpoint, and certainly from the views of some of the statehood supporters we have heard from, I think they are concerned that there is not a phaseout in both the commonwealth and statehood options.

Having said that, and recognizing the committee's difficult choices in terms of revenue-balancing and other things, though, we are here to support the balance that was chosen as a fair one. Certainly, others could be chosen.

The CHAIRMAN. Well, in your testimony you seem to support the self-executing nature of the bill. Have we ever done that before with a State?

Secretary GIDEON. I can't answer your question on that, Mr. Chairman, and I think if you look at my statement carefully, you will see that while we believe this bill should define, as it does, the major economic features so the Puerto Rican people will know precisely what they are voting on, we don't believe that you should enact in great detail all of the transitional rules that would be required under each of the three options; we think you can properly reserve the transitional legislation to a later time, once you know which choice you are legislating on.

But having said that, we understand, given the views that were expressed at the hearings earlier this year, the need for the people of Puerto Rico to know the basic economic charter that is provided under each one of these options.

The CHAIRMAN. With respect to the Constitutional issues, Ms. Peterson, it doesn't seem to me that you are following a literal interpretation of uniformity. What if statehood was phased in as 936 was phased out? Would that take care of that uniformity question?

Ms. **Peterson**. If I understand your question correctly, the answer is yes, because there would then be no special treatment of Puerto Rico.

However, I would like to comment on the question you raised regarding the literal application of the uniformity clause. Mr. Chairman, it is our view that a literal application of the uniformity clause is not required, and that the recent cases by the Supreme Court have accorded Congress some flexibility to legislate with respect to precisely-defined problems arising in geographically described areas.

The **Chairman**. But I thought the Administration generally advocated a literal interpretation of the Constitution. Interesting.

I defer to my colleague.

Senator **Packwood**. Mr. Gideon, let me make sure I understand what you are saying. You don't think the legislation, as we are currently considering it, necessarily biases the election result in Puerto Rico, one way or the other?

Secretary **Gideon**. We certainly hope it doesn't, and I think the attempt was an honest effort to not bias it in one direction or the other.

Senator **Packwood**. I know that some of the witnesses who will come later will disagree with that conclusion; but, having said that, do you still think we would be better off to do nothing about any transition provisions at all? Just leave that blank until Puerto Rico votes, and they will work it out afterwards?

Secretary **Gideon**. Let me point out, Senator Packwood, that there are substantial transition provisions in this bill. In other words, the important questions are resolved in S. 712, at the level of detail, pretty much, that the parties requested.

Senator **Packwood**. I understand that. And you are suggesting that should remain? Or would you rather do the transition provisions after the vote, depending on how the vote came out?

Secretary **Gideon**. I would rather do the remaining transition provisions afterwards.

Senator **Packwood**. But keep the existing ones?

Secretary **Gideon**. But keep the ones that are in S. 712 now. In other words, we have specific comments on the nature of some of the provisions, that are reflected in our testimony; but we think the level of detail in 712 is about right.

Senator **Packwood**. Now, refresh my memory, because I don't find it in your statement: Does the President support statehood?

Secretary **Gideon**. Yes, he does, and that is in my statement, right up front.

Senator **Packwood**. It is? I must have missed it in that long tome that you had. [Laughter.]

I apologize. I have no other questions.

There were no other questions from Senator Bentsen.

Ms. Peterson, Mr. Gideon, thank you very much.

Ms. **Peterson**. Thank you.

Secretary **Gideon**. Thank you.

The **Chairman**. The next panel will be the Honorable Rafael Hernández-Colón, Governor of the Commonwealth of Puerto Rico; Former Governor Carlos Romero-Barcelo, President of the New Progressive Party, and Former Governor Luis Ferre, the founder of the New Progressive Party; and Former Senator Ruben Berríos-Martinez, President of the Puerto Rican Independence Party.

Gentlemen?

Governor Hernández-Colón, if you would proceed, please.

STATEMENT OF HON. RAFAEL HERNÁNDEZ-COLÓN, GOVERNOR, COMMONWEALTH OF PUERTO RICO, SAN JUAN, PR

Governor HERNÁNDEZ-COLÓN. Mr. Chairman, Senator Packwood, I am here today to address an issue of vital importance to both Puerto Rico and the United States.

Sometime during the summer of 1991, the people of Puerto Rico, 3.5 million citizens, are going to exercise their right to self-determination, setting the course of their future political relationship with the United States. They hopefully will be granted the opportunity to choose among three clearly-defined and balanced options: to improve their association to the United States through enhanced Commonwealth, to become a State, or to sever all ties to the United States through independence. That momentous choice, sealing the political destiny of a people, once made, will be irreversible, binding and self-executing under S. 712.

In order for the decision to rest with the people of Puerto Rico, the U.S. Congress has to present them three balanced options. If the options are unbalanced, if Congress loads the choices in a way that steers the Puerto Rican people to select a particular outcome, it is Congress which will have made the choice, not the people.

Mr. Chairman, Senator Packwood, unfortunately the status referendum bill, S. 712, as narrowly reported by the Energy and Natural Resources Committee, is not balanced amongst the options.

The most fundamental imbalance arises out of the fact that, while the statehood option was granted parity in all Federal social programs, the Commonwealth was denied such parity in all requests made before the Energy Committee. The cash benefits arising from parity under statehood create a constituency for statehood of about one-half of the electorate and in effect will determine the outcome of the referendum. This has been measured by nationally reputable polling firms. For the first time in history, statehood has commanded a lead in Puerto Rico, as a direct effect of the bill reported out by the Energy Committee.

That Committee, however, expressly deferred to and requested the independent determination and consideration of this committee on these social programs and on issues of tax and trade, knowing that your committee has the appropriate jurisdiction and expertise with respect to these matters.

It might be useful at the outset of this presentation for me to describe the current fiscal relationship between the United States and the Commonwealth. In order to provide for self-government in Puerto Rico, Congress provided in 1917 that Puerto Rico would be fiscally autonomous. The nature of this relationship sometimes gives rise to the assumption that Puerto Rico pays no taxes yet has substantial Federal benefits. This assumption is incorrect for several reasons:

Mr. Chairman, Puerto Ricans pay much higher local taxes than is true in any State of the Union. Although tax reform measures have recently lowered rates, the top marginal personal income tax rate in Puerto Rico is still 41 percent. This is far higher than any State, and even higher than the marginal Federal rate. At every level of income, Puerto Rico's personal tax rate exceeds the U.S. income tax rate, both in marginal and average terms. For example, a taxpayer earning $50,000 in Puerto Rico pays more taxes than a person earning the same amount in a large U.S. city would pay in both Federal and State taxes.

In addition, although individual and corporate citizens of Puerto Rico do not pay U.S. income taxes, we do pay Federal Social Security taxes, unemployment insurance, and Medicare taxes, totalling approximately $1.6 billion a year.

Some Federal programs treat Puerto Rico for funding purposes as a State; others do not. Puerto Rico participates fully in Social Security and Medicare. However, Puerto Rico is given a limited block grant in lieu of participation in the food stamps program, and its citizens receive a lower level of benefits than other U.S. citizens under AABD, Medicaid, and other programs.

Mr. Chairman, we believe that the right to participate in the minimal safety net programs is a basic individual right of U.S. citizenship and should not depend on the accident of geography. Non-U.S. citizens residing in the 50 States are generally eligible for full assistance under these programs. In order to be given a fair option between statehood and commonwealth, U.S. citizens in Puerto Rico must not have to choose one over the other so as to be provided with this safety net.

The extension of the full benefits of the social programs to the needy in Puerto Rico must run parallel with the sustainable development of the Puerto Rican economy. The ultimate goal of Federal and Puerto Rican policy must be jobs, good jobs, permanent jobs, to enhance our standard of living and lessen dependency on the social programs.

In this regard, this committee is well aware of the crucial importance of section 936 of the Internal Revenue Code to Puerto Rico's economic development. Mr. Chairman, I wish to emphasize that this is not just another provision of the tax code but, rather, the very foundation of the Puerto Rican economy. Statehood would inevitably destroy that foundation.

S. 712 provides no substitute for 936. It takes the motor out of our economy and does not provide any means to keep it going. It merely provides a transition, a phasing out of 936, and even this is done in an unconstitutional manner.

You will hear today a discussion of this serious matter by eminent constitutional scholar Laurence Tribe of the Harvard Law School. It is his judgment that the 936 transition under S. 712 does not pass constitutional muster under the Tax Uniformity Clause because it permits, under Puerto Rican statehood, a continuation of tax benefits not provided to other States. For Congress to promise a deferral of tax burdens which cannot be constitutionally honored would be most serious.

Furthermore, in considering the future of our economy under statehood, it is imperative to examine the dynamic effects of the imposition of Federal taxes. The political status of Puerto Rico, and its economic future, is no ordinary tax issue, where the assumption of no change in economic behavior is appropriate.

The island of Puerto Rico, while possessing extraordinary God-given beauty, is also, in terms of economic development, burdened with inherent disadvantages. These include location, lack of natural resources, small size, lack of arable land, population density, and the need to pay higher wages than in competitive locations. Section 936, unavailable under statehood, has been the principal tool available to offset these disadvantages.

With the critical help of this tax provision, we have created entirely new manufacturing and service sectors for the Island economy, now accounting directly or indirectly for 300,000 jobs—–-fully half of our Island's private sector labor force. With this section we are now making significant contribution through twin plant projects in countries within the Caribbean Basin Initiative.

Mr. Chairman, in the interest of time, I will go to the end of my testimony.

I cannot emphasize too much the fiscal impact of statehood on the Puerto Rican government and the taxpayers who support it. We are analyzing the question carefully, and we will provide the results to the Finance Committee. At this point, however, I am confident in saying that, short of massive Federal transfers over and above individually targeted entitlement programs, there is no way for statehood to reduce local taxes. To do so would cause huge public employee layoffs and a drastic reduction in the services we provide. This is confirmed by the CBO analysis of September 6, 1989, which shows only a small net overlap between full extension of Federal programs to Puerto Rico and present programs and services of our government. This would create the necessity for ruinous business taxes and the highest personal taxes in the United States, striking at the heart of our jobs creation efforts and punishing our fragile middle class.

Thank you very much, Mr. Chairman.

[The prepared statement of Governor Hernández-Colón appears in the appendix.]

The CHAIRMAN. That is very interesting testimony, and it shows the complexity of our task in trying to achieve a level playing field.

If you would, proceed, Governor Romero.

STATEMENT OF FORMER GOVERNOR CARLOS ROMERO-BARCELO, PRESIDENT, NEW PROGRESSIVE PARTY, ACCOMPANIED BY LUIS A. FERRE, FOUNDER, NEW PROGRESSIVE PARTY, SAN JUAN, PR

Governor ROMERO. Thank you.

Mr. Chairman, Senator Packwood, thank you for inviting us to testify today. It is an honor to participate in the historic process that we hope will ultimately lead to Puerto Rico's entrance into the Union as the 51st State.

My name, for the record, is Carlos Romero-Barcelo, and I am here today in my capacity as President of the New Progressive Party, the pro-statehood party.

I am privileged to be here with Governor Luis Ferre, Chairman of the Republican Party of Puerto Rico, the founder of the New

Progressive Party, and a man who has inspired generations of Puerto Ricans in our quest for political equality. I would like the Chairman's permission to have Governor Ferre make some short statements for the record.

Governor **FERRE**. Thank you.

Mr. Chairman, Senator Packwood, I am Luis A. Ferre. I was Governor of Puerto Rico between 1969 and 1973, and I am a graduate of the Massachusetts Institute of Technology.

In a moment you will hear from Governor Carlos Romero-Barcelo, the President of Puerto Rico's statehood party. I am honored to testify on behalf of S. 712, an historic measure that would provide the people of Puerto Rico with their most cherished wish—the right of political self-determination and, I believe, eventual statehood.

Mr. Chairman, I have worked for over 50 years on behalf of statehood for Puerto Rico. I strongly believe statehood serves the best interests of Puerto Rico and of the United States.

Like all Puerto Rican Americans, I love this country, which has given us freedom and prosperity. Many Puerto Ricans have died fighting to preserve liberty in the United States Armed Forces, amongst them Fernando Garcia Ledesma, who won the Congressional Medal for the ultimate sacrifice of his life. My grandson, a graduate of West Point, serves now in the Armed Forces in Germany. He is witnessing an important episode in Democracy's progress, its inevitable fulfillment, firsthand. So am I. What Congress is doing for 3.3 million of its own citizens in this process is as important, in its own way, as events unfolding in Germany, Poland, and elsewhere. Congress is ensuring the right of self-determination.

After 50 years, people sometimes ask why I have such faith in statehood. I have positive and negative reasons.

First, the negative: It is simply wrong to deny 3.3 million American citizens, who have proven their willingness to fight and die for their country, such basic civil liberties as the right to elect a representative congressional delegation with voting rights and the right to vote for the President who sends them into battle.

More positively, the promise of a healthy, balanced economy lies in statehood—not continued territorial status and dependency. I am a common-sense businessman. My family and I have been blessed and our business has been successful, not by inheritance but by hard work. I have served on the Board of Trustees for MIT for 25 years. I have served on bank boards and U.S. commissions such as UNESCO and the U.S. Puerto Rico Status Commission. My son serves on the Boards of American Airlines and Metropolitan Life Insurance Co. Our cement company trades on the New York Stock Exchange.

We have learned something about business. It is this: Subsidy does not beget success, only precarious subsistence. My businesses have not depended upon subsidy for their success and, ultimately, neither should other businesses which comprise Puerto Rico's economy.

Puerto Rico's economy can flourish under statehood, just as the economies of other territories have, once they became States. Economies dependent upon tax exemption and government subsidy, denied the unbridled and properly deserved opportunities that only statehood can offer, ultimately are weighed down by the uncertainties of the very programs which support them.

I have devoted my life to statehood because I know the spirit and ability of the Puerto Rican people and the sense of fairness of this great nation. With each passing decade of this century, at my age of 85, I have seen Puerto Rico grow from an agricultural community of scant resources, and suffering of poverty, and limited opportunities to a dynamic society inspired and guided by the spirit of American Democracy to give every citizen an equal opportunity to enjoy the fruits of his ingenuity and toil, to have educational and health facilities of top quality, and to look with confidence to his future, with the same rights as his fellow American citizens.

As such, you must not fail us in this hour of decision.

Thank you.

[The prepared statement of Governor Ferre appears in the appendix.]

The CHAIRMAN. Thank you.

Mr. FERRE. Now Mr. Carlos Romero-Barcelo will speak to you.

The CHAIRMAN. Well, I think we had equal time for the two of you, as compared to each of the other panelists. I don't want the time to be stacked in favor of one side or the other.

Have you finished your time, or not?

Governor ROMERO. Mr. Chairman, I have not even begun. I thought, as Governor Ferre had been 50 years——

The CHAIRMAN. I just want to be sure I give equal time to the three parties. All right, sir.

Governor ROMERO. Thank you, Mr. Chairman. I will be brief. I have a very long statement, but I will just speak contemporaneously.

The CHAIRMAN. Thank you.

Governor ROMERO. I would like to say we are here to address two issues, basically: The first is the unavoidable duty of Congress to provide U.S. citizens residing in Puerto Rico with the basic rights; and the second is our reasons for believing that statehood would provide important economic benefits, both for the people of Puerto Rico and for the Federal Government.

We are living now in one of democracy's finest hours. People in every part of the world are struggling to exercise the most fundamental right, the right of self-determination. Europe's Eastern Bloc is moving en masse toward democracy. In Asia, Africa, Central and South America, the people will not be long denied—and with this legislation—the long-standing promise of self-determination for the world's oldest colony finally will be realized, for the 3.3 million American citizens living in Puerto Rico.

I was struck by Chancellor Kohl's comments last week before the German Parliament, when he said, and I quote: "The precondition for reunification and freedom is the free exercise of the right of self-determination by all Germans. I am certain that, if they get the chance, they will choose freedom and unity." This is what the people of Puerto Rico will choose, I am certain, if they get the opportunity—freedom and unity.

Self-determination, I am convinced, will lead the people of Puerto Rico to choose statehood, for the following reasons:

Because statehood means equality; because statehood means dignity; because statehood means the right to vote, and the right to representation.

It means strengthening the ties to the 50 States of the Union, which is what the overwhelming majority of the people of Puerto Rico want.

Congress should make self-determination possible with this referendum. Why should Congress make it possible, as far as the nation is concerned? Because we must look not only from our point of view but from the nation's point of view.

First, because the nation stands for democracy, and we should have the opportunity to choose our future and our destiny.

Second, because we have earned it. Over 200,000 Puerto Ricans have served in the World Wars and the different wars, more than any territory before it became a State. In the Korean War, Puerto Rico was second in the number of wounded, third in the number of deaths; yet, we are twenty-sixth in population, compared to the 50 States of the Union.

Congress should grant us statehood status because we will be contributing to the Treasury. In the commonwealth status, the people of Puerto Rico who can afford to pay do not contribute to the Treasury. As a State we will be contributing, paying our share as we go.

Third, because our location and our patriotism make us important to the national security, particularly as Panama phases out. And as Guantanamo Bay will be surrendered, Puerto Rico becomes a key for the Caribbean and Central America from a strategic point of view for the nation, and because our Hispanic culture gives us a real tie with Latin America. It is not the same for the United States to get involved in Central American and Latin America affairs, from the point of view of the colony or the territory in the Caribbean, Puerto Rico, as it would be if Puerto Rico were a State. From the point of view of a State right in the midst of the Caribbean, the United States would have a real vested interest in the Caribbean and Central America.

Fourth, and fifth, because our Hispanic culture gives us a real tie, and because 3.3 million U.S. citizens deserve the right to vote and to representation.

We have been now a colony since Columbus landed in Puerto Rico in 1493. We are about to celebrate the 500th anniversary of the discovery of America, and Puerto Rico is the oldest colony.

You might argue the fact of whether Puerto Rico is a colony or not; but the perception of the rest of the world is that it is, and perceptions are what counts. We do not participate in the making of the laws to which we are bound; we have no right to vote in the nation that we are citizens of; and from the world's perception, we are a colony. That is a blotch on the image of the nation. We should erase that blotch in 1993.

Finally, I want to address myself to the comparative evenness of the statehood and the commonwealth. The Governor says that the State will be granted all of these programs, which will tilt the balance in the elections in favor of statehood. This is not a grant; this is a matter of right. We want to have the same treatment, equal treatment, but we want to contribute, we want to pay. We want to pay our taxes.

When I was Governor, I came here and asked for parity. It was denied. I will ask for parity for my people again; but I have to swallow my pride when I ask for parity, because those of us who can contribute are not contributing. We are asking for the opportunity to pay our way, so that those of Puerto Rico who do not have sufficient resources, who are needy and poor, will have the same benefits as the citizens in the rest of the nation. That is what we are asking for with statehood, and no one can say that it is giving an advantage to Puerto Rico to make it the same as all other States when we become a State. And that is what we will achieve. When we become a State, we have the right to parity, but our citizens will also be paying. We will achieve dignity and self-respect. We do not want to continue as a commonwealth, welfare-state, which is now a bottomless pit for the treasury.

You will see in later testimony that the contributions coming in from Puerto Rico, the taxes, will more than pay off for the shortest-term advantages of the transition period.

Thank you very much.

[The prepared statement of Governor Romero appears in the appendix.]

The **Chairman**. Thank you, Governor Romero.

Senator Berríos-Martinez, we are pleased to have you.

Senator Berríos-Martinez is President of the Puerto Rican Independence Party.

Please proceed.

STATEMENT OF FORMER SENATOR RUBEN BERRÍOS-MARTINEZ, PRESIDENT, PUERTO RICAN INDEPENDENCE PARTY, SAN JUAN, PR

Senator **Berríos-Martinez**. Mr. Chairman, Senators Packwood and Bradley, I am here to testify on the trade, fiscal and economic provisions of S. 712.

We commend the Committee on Energy and Natural Resources, and particularly Senators Johnston and McClure for their thorough and conscientious work. However, there is still room for improvement regarding the economic provisions under independence contained in S. 712.

This morning I wish to provide a broad policy framework which will serve as a basis for our specific proposals. The Puerto Rican economy is chronically ill. An appearance of normality is achieved only through massive U.S. subsidies and massive migration.

Average unemployment in Puerto Rico during the last decade has been 19.5 percent, and if unemployment in Puerto Rico were measured by U.S. labor-participation standards, average real unemployment during the last 10 years would have been 40 percent. More than 400,000 Puerto Ricans have migrated to the United States during the same 10-year period.

United States subsidies and other payments to Puerto Rico, not including Social Security, totalled $27 billion in the last decade, while income from U.S. investments in Puerto Rico amounted to $58 billion.

In short, during the last 10 years, the U.S. taxpayers subsidized the Puerto Rican economy to the tune of $27 billion, while U.S. companies in Puerto Rico obtained more than double that amount as income, mostly from federally tax-exempt 936 corporations. It should come as no surprise that under such extreme conditions of economic dependence, Puerto Rico is fast becoming a tropical ghetto.

Faced with these realities, the different status alternatives should be directed towards lessening the burden of such costs, both to the United States taxpayers and to Puerto Rico. From that perspective, independence is by far the most convenient alternative, both to the United States and to Puerto Rico.

Taking the Congressional Budget Office figures as a basis and conservatively extrapolating them for a 10-year period starting in 1992, the statehood alternative would cost the U.S. Treasury $37 billion more than the present level of funding to the Island economy, which, by itself, would amount to $56 billion during the same 10-year period. This means that both statehood and commonwealth, if parity in funding is granted to the latter alternative as requested by the Governor, would cost the U.S. Treasury the astronomic amount of $95 billion during the 10 years extending from 1992 to 2001.

If one were to optimistically estimate the Federal budget deficit for 1992 at about $100 billion, the cost of Federal budget outlays for Puerto Rico in that year would account for 8 percent of the Federal budget deficit.

In contrast, the independence option represents no less than $10 billion in savings over the same 10-year period when compared to the present commonwealth status, and $47 billion in savings when compared to commonwealth if parity in social services is granted.

With respect to statehood, independence represents a savings of $47 billion minus whatever amount is eventually collected from Federal taxes in Puerto Rico. Needless to say, U.S. block grant obligations under the present legislation would cease with independence after a 9-year transition period, and U.S. aid after that period would be subject to negotiations between both nations.

On the other hand, on the commonwealth or statehood, the United States taxpayer faces a bottomless pit of ever-growing expenditures, per secula, seculorum. Independence, as defined in S. 712, is designed to break the straitjacket of extreme dependence through a rational and orderly transition to this status alternative. The 9-year transition grant contained in S. 712, the trade and other economic arrangements which we have proposed, and the sovereign powers which the independence option entails will provide Puerto Rico with the necessary tools to implement an economic development program designed to minimize economic dependence.

Finally, I must refer to the proposal made by the Governor of Puerto Rico, requesting parity in the application of U.S. social programs to Puerto Rico. This request that the Commonwealth of Puerto Rico be treated as a State in all aspects except fiscal responsibilities and voting rights raises extremely serious questions:

First, it would make commonwealth more costly than statehood, since Puerto Rico would receive the same funds, more or less, as a State, but would not pay Federal taxes.

Second, it raises an even more crucial question of a political and moral nature. Statehood is neither in the best interests of Puerto Rico nor in the best interests of the United States, and it is my conviction that this reality is now in the process of being internalized by an ever-growing number of senators and Congressmen as a result of the debate and discussion unleashed by this legislative process, precisely at the time when the inclination toward statehood is at its highest point in Puerto Rico. Many who are becoming worried of the statehood majority in Puerto Rico, and who have historical misconceptions regarding independence, may be tempted to look kindly upon the request for parity as a desperate attempt to equip the defenders of commonwealth with an electoral weapon that would make victory possible over statehood in the proposed plebiscite.

If one adds to this the fact that the notion of parity has the ring of equality and fairness attached to it, parity might appear as an irresistible, if costly, solution to the dilemma of how to prop up commonwealth so that it will keep statehood in the minority for another generation.

Congress has the right, perhaps even the responsibility, not to grant statehood; however, no one has a right to propose that Congress purchase the political dignity of the Puerto Rican voters by promising that 60 percent of Puerto Ricans who still live in poverty a cornucopia of Federal transfer payments if they vote for the present colonial status of political subordination. That is, if they renounce their right to political equality and representation, which they would enjoy under statehood, under independence, or under sovereign, free association as defined in international law.

Under no conditions should Congress allow a status of colonialism or political subordination to appear on the plebiscite ballot, much less with the seductive inducement of providing the economic benefits of statehood without the financial responsibilities of statehood.

If Congress merely wants to prop up the present territorial or colonial status by multiplying Federal subsidies, it should limit itself to that endeavor and put aside any pretensions regarding self-determination. To do otherwise would make a mockery of the principle of self-determination and render the proposed referendum totally unnecessary.

Thank you very much.

[The prepared statement of Former Senator Berríos-Martinez appears in the appendix.]

The CHAIRMAN. Thank you very much, Senator.

I was looking over the resumes of the heads of the political parties. In reviewing the background, experience, and education of each of you, I was quite impressed that the people of Puerto Rico have candidates of your stature representing them in public service. That is certainly to the credit of Puerto Rico.

Governor Romero, you talked about Federal benefits as "a right" of the people. Shouldn't they also bear the responsibility for the taxes to pay for these benefits?

Governor ROMERO. Right. Definitely.

The CHAIRMAN. During the transition period, the taxpaying obligations are phased in. How would you reconcile those two points?

Governor Romero. In the following manner:

The people who will receive the benefits are not the ones that will pay the taxes. It would be unfair for them to be held back until such time as the taxes were coming in, because as Puerto Rico becomes a State, then they are entitled to equal rights as all the other citizens in the nation. I mentioned that during the hearing in the committee. I said we were willing to accept, if that is what the Congress wants, to also wait for the time to have a transition period; but it is the needy people that would be made to wait, and I think it would be fair because they are not now having to pay the taxes, and they will not have to pay the taxes. The ones that are receiving the benefits from the commonwealth are the ones that can afford to pay, the ones that have the tax exemptions, and it is because they are having tax exemptions that the people do not receive the benefits that they do in the rest of the States.

The Chairman. Well, I don't think you would be treated exactly the same as other citizens during the transition period.

Senator Berríos-Martinez, did you say that Puerto Rico would become a tropical ghetto?

Senator Berríos-Martinez. That is correct.

The Chairman. Now, come on, Senator. How does the standard of living and the per-capita income in Puerto Rico compare with its neighbors? They are substantially higher, aren't they?

Senator Berríos-Martinez. It compares to the ghettos in the United States. That is what I was referring to. We have to compare ourselves to ghettos in the same situation.

The Chairman. I think, though, when you are talking about independence, you have to consider what has happened in the neighboring countries that are independent. I would say Puerto Rico has done very well, compared to them.

Senator Berríos-Martinez. That is not due to the fact that we are not independent, Senator; that means "in spite of colonialism" we have been able to improve our economy.

The Chairman. All right.

Governor Hernández-Colón, does the concept of a level playing field mean that all these options should cost the taxpayers of the United States the same amount of money? Is that an even playing field? I am not sure that that is the right principle.

Governor Hernández-Colón. No, no.

The Chairman. I wonder whether the taxpayers of this country would be willing to assume a greater responsibility if Puerto Rico were to choose statehood rather than independence, as Senator Berríos-Martinez wants. Should we accept the same financial obligations if Puerto Rico chooses independence, rather than statehood or commonwealth status? In other words, should the cost to the taxpayers be the same for each of these options? I that what it means to provide an even playing field?

Governor Hernández-Colón. They do not represent the same costs. But when the options come before the Puerto Rican electorate, you cannot have the benefits, the economic benefits, stacked up in such a way on the side of one of the options so as to make that option irresistible over the others on account of political reality.

The Chairman. From an economic standpoint.

Governor HERNÁNDEZ-COLÓN. From an economic standpoint, yes.

The CHAIRMAN. Do any of you have a different opinion on what the criteria should be for what constitutes an equal playing field?

Governor ROMERO. First of all, I don't think that it is possible to have an even playing field. You can try to be as fair and as just as possible with each of the options; but it cannot be even, because there are uneven differences.

For instance, as a State, we vote, we have a right to representation, and we pay taxes, therefore we have the same rights as all the other citizens in the rest of the nation.

Under the commonwealth option, you don't pay taxes, but you have tax exemptions, not only for the people of Puerto Rico but for the subsidiaries of corporations from the United States So those benefits are there, and those benefits will not be there for statehood.

So there will never be an even field in taxes. But in benefits, of course, being a State has additional benefits; it is a matter of being a State. There is nothing wrong with a nation saying, "I am willing to give you much more if you are part of us, in the same house, when we are partners and brothers, than if you are just a little bit separate or if you are completely separate. There is nothing wrong with statehood being a preferred choice of U.S. citizens and having it reap more benefits for U.S. citizens; that is part of what it is all about. That is the success of the nation. That is why we benefit as a nation.

The CHAIRMAN. Senator Berríos-Martinez?

Senator BERRIOS-MARTINEZ. There are intrinsic differences between the three status alternatives. Our status alternative, by far, obviously is least expensive to the United States, because after a 9-year period the transition is phased out. We say, in our position, that we are willing to go to the plebiscite, even though they will use that argument against us—they will use the cornucopia argument against us. We will promise work, dignity, and self-assurance of Puerto Rico in its own destiny. They will promise U.S. subsidies, either through statehood or commonwealth. That is the big difference. So of course they are intrinsically different.

We hope that before the 9-year transition period we can tell the United States, "We don't want any more grants. It is all right with the grants for the first 5 years; from now on, give the money to people who need it more than us, all over the world." You see? So our way out is supposedly an uneven playing field for us, but it is the only one we can preach with dignity.

The CHAIRMAN. Senator Pryor, would you preside while I attend the reconciliation in the conference.

Senator PRYOR. Yes, Mr. Chairman. I would be happy to.

The CHAIRMAN. Thank you.

Senator PRYOR. I have planned to come and take over here. I must say, Mr. Chairman, I am not quite sure exactly what our situation is. I assume that the four members of this panel have made their statements and have been questioned adequately by the Chairman.

The CHAIRMAN. That is correct. But not questioned adequately. [Laughter.]

Senator PRYOR. Thank you, Mr. Chairman.

With that, let me just say are there any follow-up statements that any of you gentlemen would like to make?

Governor Ferre?

Governor FERRE. I would say that we are not asking for any subsidy as a State of the Union; what we are asking as a State of the Union is to have the same benefits and the same privileges as all other States of the Union, within all the transitory periods during which Puerto Rico's economy can be adjusted, to assume all the responsibilities of statehood. We will assume the responsibilities of statehood, but we will have representation in Congress in order to be equal to the other States of the Union. And we are sure that in that moment we will be able to stimulate the economy of Puerto Rico, to the extent that our economy will continue to prosper and will come to the level of all the States of the Union.

Senator PRYOR. Thank you for your statement.

Any other follow-up questions or comments?

Governor ROMERO. Yes, I would like to make some comments, Senator.

Senator PRYOR. By the way, I don't know—and please don't hold me guilty if I am allowing more time and not allowing equal time for each participant. But, Governor, you are recognized.

Governor ROMERO. Thank you.

Senator, Puerto Rico's developed economy at the present time, under the present status, is said to be dependent upon tax exemptions. Those tax exemptions have served us well, but I think we have reached a point in time when those tax exemptions are now preventing Puerto Rico from moving on to where we should be, in parity with the rest of the nation, to become a State, to have equal rights, the right of representation, the right to vote, to share also in the cost of the nation, to contribute, to pay our way.

In order to make that change, because we have been dependent on these tax exemptions, we feel that there should be a transition period, so that the changes from one system of not paying Federal taxes to another system of starting to pay Federal taxes creates as little dislocation as possible and the transition is as smooth as possible.

So this is one of the issues in this, how long that transition period should be, and whether or not it violates the Uniformity Clause of the Constitution.

There has been testimony here today to the fact that it does not violate the Uniformity Clause and that it is necessary so that it does not create those serious dislocations. We believe that once Puerto Rico becomes a State, the other benefits—the security, the stability, the confidence of investors, the additional funds and allocations for Puerto Rico—will all provide additional financial stimulus to Puerto Rico that will bring Puerto Rico up to a higher standard of living and a much higher level of employment than we now have.

But there are a few years wherein we need to make some adjustments, and that is all we are asking for, for that adjustment period. Otherwise, I think that we should have it.

Senator PRYOR. Senator Berrios-Martinez?

Senator **Berríos-Martinez**. Senator, I have finished my statement. Unless you have another question, I might ask for you to excuse me.

Senator **Pryor**. Good. I am about to excuse all of you. I have no questions. Thank you very much, all of you.

We have another panel, and I would ask that panel now to take their places:

Mr. Gerardo Carlo, Tax Attorney from Puerto Rico and Mr. Michael McKee of Quick, Finan and Associates in Washington, DC; Mr. Manuel Rodriguez-Orellana, Counsel to the President, Puerto Rican Independence Party, and Mr. Eric Negron, Special Advisor, Tax Matters; and Mr. Antonio J. Colorado, the Administrator, Economic Development Administration, Commonwealth of Puerto Rico, San Juan.

I believe all of you are in your place. I hope I did not mispronounce too many names nor leave anyone out.

At this time, gentlemen, I am going to invoke the 5-minute rule. It is my understanding that the other panelists had a 10-minute time period, but I am going to invoke the 5-minute rule, and I hope that you will be cooperative in that respect.

We will first hear from Mr. Carlo.

Mr. Carlo, I would ask that you and all of the other panelists bring the microphone very close to you so we can all hear.

STATEMENT OF GERARDO CARLO, TAX ATTORNEY, CARLO AND DUBOS, SAN JUAN, PR, ACCOMPANIED BY MICHAEL J. McKEE, PRINCIPAL, QUICK, FINAN & ASSOCIATES, WASHINGTON, DC

Mr. **Carlo**. Thank you, Senator.

For the record, my name is Gerardo Carlo. I am an attorney with a law firm in San Juan, Carlo and Dubos, practicing incorporated tax law. I was previously Director of the Puerto Rico Income Tax Bureau under the administration of Governor Ferre.

I also have with me Michael McKee, the principal of an economic studies firm in Washington, Quick, Finan and Associates, who is doing a study about the impact of statehood on the economy and the fiscal matters of Puerto Rico, which we hope will be ready in a short time. We will present it to this committee at the appropriate time.

Because we have such a short period of time here, with the 5-minute rule that has been invoked, I wish to say that the fiscal and economic integration of Puerto Rico, of 3.2 million people, into the U.S. fiscal/economic situation is not an easy task. We have been dealing with this since this bill was initially introduced in the Senate. We still don't have all of our points down.

It was very good to hear from the Departments of Treasury and Justice today, clarifying and giving us some input and data which we will use as part of our studies, which in turn will clarify all of these doubts.

I do wish to say that I have heard today arguments about parity, arguments about equal treatment, arguments about uniformity. There is an issue, also, about being represented, and having laws applied to you without adequate representation in Congress.

We are subject to Federal taxes. Although we are exempted from Federal taxes, we are paying Federal employment taxes in Puerto Rico. We are paying a series of taxes that apply to or are summarily rebated to a local government, but they are paid by individuals. And as these Federal employment taxes grow larger and larger compared to the lower income taxes, it becomes more and more important to look at the Puerto Rico issue not only as a tax and fiscal matter but also as a civil rights or civil liberties, if you wish, matter.

In terms of the importance of the study that we are preparing, I would rather give my time to Mr. McKee, Principal, Quick, Finan and Associates, to talk about some of the results that he has found in his study of the integration of Puerto Rico into the fiscal system of the United States.

Senator PRYOR. Mr. McKee?

Mr. MCKEE. Thank you, Mr. Chairman.

I am Michael McKee, Principal and Managing Director of the firm of Quick, Finan and Associates, appearing today on behalf of the Statehood Party of Puerto Rico.

I thank the Senate Committee on Finance for consenting to hear our views on the tax and economic implications of admitting Puerto Rico into the Union of States.

Previously I served as a senior staff economist to the President's Council of Economic Advisors, and in the U.S. Treasury's Office of Tax Analysis, as well as at the Organization for Economic Cooperation and Development in Paris. For more than a decade I have specialized in analyzing structural adjustment issues, that is, how shifts in taxes, regulations, development policies, and other actions that change the underlying structure of the economy affect economic growth and performance.

I would like to make three basic points today:

Section 936 has helped to overcome the inherent disadvantages associated with non-statehood and helped to build a stronger economy in Puerto Rico; but, my second point,

The future growth potential of Puerto Rico's economy can be best realized under statehood.

Third, phasing out section 936 may cause some economic disruptions, but far less serious than the proponents of commonwealth might lead you to believe. These disruptions can be further reduced by appropriate transition policies.

Statehood will keep many companies and attract new ones. Federal tax incentives, grouped here under the heading of section 936, have been very good for the Puerto Rican economy. Section 936 historically was an important engine of economic development on the Island, drawing many companies and entrepreneurs to the Island, generating high-paying jobs, developing skills and experience, attracting capital, helping to improve the educational system and build the Island's infrastructure, and boosting the incomes of many Island residents. For these benefits, one must thank the U. S. Congress and the companies that have been part of this development.

What of the future? What would happen if the Federal tax incentives continue to be decreased and eventually end? What would be the reactions of the current section 936 companies and of other companies considering location on Puerto Rico without these generous tax benefits?

Mr. Chairman, two kinds of companies have come to the Island and have taken advantage of section 936—those that may have reason to leave if section 936 ere eliminated, and those that will stay with or without the section 936 benefits. These companies differ in many ways, but they have one common denominator: they had good tax advisors.

Consider, first, the companies that will stay even if 936 is phased out. They are companies that have come to Puerto Rico and have learned about its economic and strategic advantages. They belong in Puerto Rico for real economic reasons, not artificial tax advantages. They will stay and flourish. Initially, however, they needed good tax advisers to find the Commonwealth of Puerto Rico and assure them of its economic advantages.

Recently we reviewed the treatment of Puerto Rico by business location experts, international commercial organizations, and the popular press. "Is the Commonwealth of Puerto Rico part of the United States? A foreign country? Something else?" We found that virtually all sources regard the United States as being the 50 States and the District of Columbia. Puerto Rico is a foreign location, if it has any status at all. Indeed, we sometimes had considerable trouble locating Puerto Rico as either United States or foreign.

For example, the Places Rated Almanac bills itself as "Your guide to finding the best places to live in America." It is one of a number of such reference guides that assist individuals and businesses in making location decisions. Puerto Rico is not mentioned. Similarly, most such rankings of U. S. cities ignore Puerto Rico and San Juan.

The Washington offices of the American Automobile Association contain none of the organization's panoply of maps, triptiks and tour guides for Puerto Rico, yet the organization said it had such information for the United States, Canada, and Mexico. The only information on Puerto Rico was to be found in a guide that even members had to buy, entitled, "Bahamas, Bermuda, and the Caribbean." If Puerto Rico were a State, it would not have to rely on astute tax advisors to overcome these and other obstacles to ignorance.

Puerto Rico has a number of natural advantages and a number of advantages that have accumulated because of section 936. But what about the companies that would leave? Some, perhaps, would leave. No doubt the proponents of section 936, in studies in the past, have overstated the impact of removing section 936. One such recent study just a few years ago said that even in the worst case, were section 936 removed and replaced by nothing, the Puerto Rican economy after 2 years would start to grow at 2.4 percent, roughly the growth of the United States

Senator PRYOR. Thank you, Mr. McKee.

Mr. MCKEE. Thank you.

[The prepared statement of Mr. McKee appears in the appendix.]

Senator PRYOR. I want both of our panelists to know, each of you, that your full statement will be printed at the appropriate place in the record, and we appreciate your testimony very much.

Mr. McKee. Thank you, Mr. Chairman.

Senator Pryor. Our next twosome is Mr. Orellana, who is Counsel to the President of the Puerto Rican Independence Party, and Mr. Eric Negron, Special Advisor for Tax Matters.

I am going to give each of the two gentlemen 5 minutes, and then we will see how much time Mr. Colorado will need.

Mr. Orellana.

STATEMENT OF MANUEL RODRIGUEZ-ORELLANA, COUNSEL TO THE PRESIDENT, PUERTO RICAN INDEPENDENCE PARTY, ACCOMPANIED BY ERIC NEGRON, SPECIAL ADVISOR, TAX MATTERS, SAN JUAN, PR

Mr. Rodríguez-Orellana. Thank you, Mr. Chairman.

For the record, my name is Manuel Rodriguez-Orellana, and, as you indicated, I am Counsel to the President of the Puerto Rican Independence Party.

We have submitted a statement, which we would kindly ask you to place in the record.

Senator Pryor. Your full statement will be placed in the record.

Mr. Rodríguez-Orellana. We will be very brief here, to give you an overview of what the statement is.

Senator Pryor. Thank you.

Mr. Rodríguez-Orellana. Mr. Negron, our special advisor on tax matters, is here with me to answer any questions which you might have.

The position of the Puerto Rican Independence Party is that we are convinced that independence is the most economically convenient path for the Island. In fact, we see independence as a necessary step for solving the problems that were mentioned earlier by Senator Ruben Berríos-Martinez, the president of my party, in his statement this morning.

But we do not lose sight of the fact that, while independence is better than commonwealth, it is also different from commonwealth.

In complex endeavors, changes usually work better when they are implemented smoothly rather than when they are implemented in a drastic manner. Puerto Rico's economy has been molded on the combination of Federal and local tax exemption made possible by section 936. The change towards a new set of incentives would necessarily take time. Government planners would need to readjust their promotion strategies and infrastructural priorities, and companies which have established themselves on the Island, lured by section 936, would have to adapt to new avenues of profitability.

With these realities in mind, the Puerto Rican Independence Party has formulated its initial draft proposal for S. 712, stating that the tax credit allowed under section 936 should remain in effect for a 15-year period after the proclamation of independence.

This period is similar to that which has already been granted in the Micronesian Compacts of Free Association, which have been adopted by the U.S. Congress in recent years. Therefore, I fail to understand the distinction that was made by the Administration as to any most-favored-nation problems that might arise in these circumstances. In fact, no discrimination would occur under the Most Favored Nation clauses, because nobody would be worse off. We are talking about a transition period here, for which there is already a precedent set by this Congress.

Unlike the Micronesian Islands, however, Puerto Rico has been made to depend heavily on section 936 for more than a decade; and yet, Senate Bill 712 does not currently contemplate the phase-out of section 936 after the proclamation of independence.

What we would like to do is urge the Finance Committee to seriously reconsider this aspect against the background of dependence, which justly requires a transitional arrangement. Furthermore, from the standpoint of the U.S. Treasury, it makes virtually no difference to maintain or eliminate the 936 credit if Puerto Rico became independent, because of the foreign tax credit mechanism. And in my full statement I elaborate this point in greater detail.

The complexity and the importance of the stakes involved demand a careful transition. The U.S. Government created the monster of colonial dependence in Puerto Rico, and it is consequently the U.S. Government which has the primary responsibility for prudently phasing out all aspects of such dependence.

We would have been on our feet long ago if the United States had not taken over our economy and structured it in a manner different from that which we could and probably would have chosen. What we want is for Puerto Rico to finally stand solidly on its feet as an independent nation, without special concessions from the United States.

Thank you very much.

Senator PRYOR. Thank you very much, Mr. Rodríguez-Orellana. Mr. Negron?

Mr. NEGRON. Senator, we came prepared to use only the 5 minutes allowed, so I defer to the next panelist.

Senator PRYOR. Thank you. I don't want you to go back home, though, saying we did not grant you an ample opportunity to speak. We want to be totally fair.

Mr. NEGRON. We want to use the ample opportunity to answer your questions.

Senator PRYOR. Yes. We are going to have a few questions, also. Mr. Colorado, how much time do you need?

Mr. COLORADO. I will need approximately the 10 minutes, if possible.

Senator PRYOR. How much?

Mr. COLORADO. About the 10 minutes, maybe a few minutes less.

Senator PRYOR. Can we try seven? I will compromise with you. I fear that we are going to be having a vote shortly, and I don't want to just leave you sitting here while I have to go vote, so let us try seven.

Mr. COLORADO. Yes.

Senator PRYOR. Thank you, sir.

STATEMENT OF ANTONIO J. COLORADO, ADMINISTRATOR, ECONOMIC DEVELOPMENT ADMINISTRATION, COMMONWEALTH OF PUERTO RICO, SAN JUAN, PR

Mr. COLORADO. Mr. Chairman, it is my pleasure to appear before the committee to discuss the importance of section 936 of the Internal Revenue Code to the economy of Puerto Rico.

Section 936 and its predecessors have been effectively utilized by Puerto Rico to counteract the effects of overpopulation, lack of resources, distance from the mainland, and Federal legislation which increases our costs of production and transportation, but clearly does not burden other countries that compete with us. Over the past 40 years the development of Puerto Rico's economy from agriculture to manufacturing has often been referred to as an "economic miracle." This accomplishment is attributable primarily to section 936, and to Puerto Rico's industrial incentives legislation.

United States corporations are by far the most significant source of investment in Puerto Rico, although an increasing number of foreign and local industries are being established. In order to understand why the investment is so substantial and beneficial to both the United States and Puerto Rico, it is necessary to understand the interaction of our tax laws.

Section 936 exempts Puerto Rico manufacturing and service profits of an electing U.S. corporation from U.S. corporate income tax. In addition, section 936 provides an exemption for income from the investment of such profits for use within Puerto Rico and, since 1987, within those Caribbean countries which have entered into a Tax Information Exchange Agreement with the United States.

Unlike a State, Puerto Rico enjoys fiscal autonomy. It is a separate tax jurisdiction outside of the Federal sphere. The Government of Puerto Rico is solely responsible for its tax laws and has primary taxing jurisdiction on any income sources within its boundaries.

In order to provide an incentive for investment in Puerto Rico, we have enacted a series of industrial incentives acts that provide certain investors with tax benefits for a period of years.

Investment of tax-exempt earnings made by section 936 corporations in Puerto Rico's financial institutions are regulated by Puerto Rico to ensure that the same are utilized in productive areas that benefit our economy and those of qualified Caribbean Basin countries.

Our economy derives significant benefit from the manufacturing and service activities of section 936 corporations. To illustrate the enormous significance of the manufacturing sector to the overall economy of Puerto Rico, a 5-percent reduction in Puerto Rico's gross production in manufacturing would be the equivalent of eliminating all agricultural production in Puerto Rico. A 10-percent reduction in manufacturing would be the equivalent of eliminating all tourism in Puerto Rico.

In addition, section 936 funds on deposit with Puerto Rico financial institutions have a significant beneficial effect on every aspect of our economy.

There is, unfortunately, a direct correlation between the performance of the Puerto Rico economy and the legislative status of section 936. After "Treasury I" was issued in November of 1984, new investment in Puerto Rico from the United States virtually halted. This reaction was also experienced in 1982, during the TEFRA legislative process. Thus, it appears that whenever Congress and Treasury raise the specter of modifying or repealing section 936, immediate adverse consequences develop within Puerto Rico.

September employment statistics, released last week, show that total employment in Puerto Rico has grown to 916,000, an increase of 20 percent over the figure for September of 1984. Manufacturing employment stood at a historic high of 172,000, which represents an increase of 25 percent over the comparable figure for September of 1984. The unemployment rate has fallen to 15 percent, still much higher than we would like but significantly better than the 20.5 percent in September five years earlier.

The Caribbean Basin Economic Recovery Act was enacted in 1983, with no provision for investment incentives to stimulate the creation of enterprises that would be able to take advantage of duty-free access to the U.S. market offered under the new legislation. In order to make the CBERA program more effective for the region, the Commonwealth of Puerto Rico proposed the promotion of complementary projects between Puerto Rico and the CBI countries. This program, in addition, is stimulating the use of low-cost financing available in Puerto Rico for eligible CBI countries.

The program is now gaining momentum, and we believe it is well on its way to surpass the objectives contemplated by Congress in 1986. Over $165 million in financing for Caribbean Basin projects have been promoted. Moreover, an additional $400 million of project are in the process of being promoted or are awaiting ratification of Tax Information Exchange Agreements. So far, over 12,000 direct manufacturing jobs have been promoted in the Caribbean.

An economically strong Puerto Rico is crucial to maintaining the stability of the Caribbean region. It is irrefutable that section 936 has worked, in combination with the Puerto Rico Industrial Incentives Legislation, to create the strongest economy in the Caribbean.

We must also note that Puerto Rico is engaged in a significant trade relationship with the United States that is based on section 936. In 1988, Puerto Rico imported close to $9.5 billion from the United States, more than all of the countries of the Caribbean and Central America together, more than Argentina, Colombia and Brazil together, and more than twice and a half the imports of Israel. This generates more than 170,000 jobs in the mainland. This would not be there if it weren't for section 936.

In addition to being a good market for U.S. products, Puerto Rico helps keep America competitive in global markets. Exports from Puerto Rico to foreign countries grew by 37.5 percent between Fiscal Year 1988 and 1989.

Congress needs to have a clear understanding that section 936 is a vital economic link between the United States and Puerto Rico which is of critical importance to Puerto Rico and the Caribbean and which benefits the United States as well. Tampering with section 936 can only cause economic harm to Puerto Rico.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Colorado appears in the appendix.]

Senator PRYOR. Thank you, Mr. Colorado.

I am going to try to engage in sort of a family discussion, if we can call it that, or maybe a colloquy, as we call it in the Senate. I am going to ask all of you this question.

I have heard, since I have been here, that S. 712, as now drafted, is slanted or tilted in favor of one of the three options. Now, could we all express a view here? Is S. 712 tilted in favor of one of the three options we are discussing today?

Now, you have to lecture me, because I have not read this piece of legislation, and I need an education, and I imagine there are several on the committee who do.

Mr. **Carlo**. Yes, Senator.

Senator **Pryor**. Mr. Carlo? We will try to have some brief answers here on this complex issue.

Mr. **Carlo**. Sure. This so-called tilting argument arises out of a complaint of the Popular Democratic Party that the bill that has come out of the Senate Energy Committee affords equal treatment to U.S. citizens, parity, in a series of Federal programs that we have been actually discriminated against for many years, for different reasons. This has been upheld by Federal courts, unfortunately. I don't believe it is right.

Recently we had some hearings before the Senate, last week, where some of the Senators who head this committee on food stamps very strongly said that this was discrimination and, irrespective of this bill, should be wiped out.

So there was nothing that the Senate Energy Committee could do but tell the U.S. citizens in Puerto Rico, "You are equal citizens." Anything else would have been unconstitutional, would have required a constitutional amendment. So the whole argument, I think, has no basis.

I don't hear anyone complaining about the fact that the bill is tilted in favor of the independence option, which I think it is. It doesn't cost the United States anything to give Puerto Rico independence, or very little.

Senator **Pryor**. Well, let us hear from Mr. Rodriguez-Orellana on that.

Mr. **Rodríguez-Orellana**. Let me say briefly that the issue of whether the bill is tilted in one direction or another has been raised as a political question by the Popular Democratic Party and the New Progressive Party. It is kind of a shameful discussion, because what they are arguing about is who is going to get more dependence money.

I think I will leave that argument for them to continue to battle it out; I would just simply like to concentrate on what the bill states in all of the major sections that correspond to this committee's interests.

Specifically with regard to that, I want to stress the fact that there is a transition period provided in the bill, as reported, for statehood, that no statement is made as to the existence of section 936, whether it is a permanent feature of commonwealth or not, and I think it should be clarified by the Congress. And for the same transition period, I think it should be a substantially longer transition period in the case of independence, for the reasons that we have stated. There should be no discrimination between the statehood option and the independence option in terms of allowing for a section 936 transition period.

Senator **Pryor**. We are going to talk in a moment, if we might, about transition.

Now let me ask the original question to Mr. Colorado, about the tax provisions in S. 712. Is it tilted, slanted, in any direction?

Mr. COLORADO. I will not talk on behalf of the Popular Party as such, but as Administrator of the Economic Development Administration I can raise the issue of what will people vote for at that time. I think it is important that, whichever way the bill finally comes out, it will not make it an incentive for people not to vote for statehood because they want statehood but because they are going to get something else immediately that otherwise they would not, not realizing that there are other parts in the other statuses, either independence or commonwealth, which are also very important to the future growth of the Island and in the future economic development of the country itself.

Senator PRYOR. All right. Let us shift gears for a moment, if we might, and talk about the transition rules, as in S. 712.

I will just start with you, Mr. Colorado; you have the floor now, and we will just work backwards. What about the transition rules in this piece of legislation? Do you feel that they are fair, that they are adequate, inadequate, or need to be re-looked at or revisited?

Mr. COLORADO. My statement shows the importance of 936, so I think 936 is important under the commonwealth option, and it is important under the others also. Now, the thing is, what are the possibilities of having 936 under the other statuses. Under independence, obviously you could have it; it is just a matter of the policy of the Untied States not to grant tax sparing to foreign countries. But other countries do so, like England does with Singapore, like Japan does with many other countries. So the possibility of section 936 under independence exists.

In the case of statehood, I think the issue is basically a constitutional one: Can Puerto Rico enjoy 936, be it for a period of a few years or be it for a long time, under statehood? And I think that issue, the constitutional issue, will be discussed in the next panel.

Senator PRYOR. Mr. Rodríguez-Orellana?

Mr. RODRÍGUEZ-ORELLANA. Yes. I just want to reiterate what I said before. I think, as far as the tax aspects, there should be a transition period provided for independence, as well, for section 936.

In terms of the economic benefits of the other economic measures, we have other positions that will be presented in the subsequent panel, as well.

Let me just say that there doesn't appear to be, from the bill, any need for a transition under the so-called commonwealth option, because all it is doing is modifying Federal laws which already apply. So we are not really talking here about any transition; what we are talking about here is the continuation of the same status. And I think, to that extent, the bill contains a very drastic flaw, because it is not offering an alternative to the problem, which is commonwealth.

Senator PRYOR. Thank you.

Mr. Carlo? We are on the transition issue. Would you comment on that?

Mr. CARLO. Yes, Senator. I think there is no question that we need a transition for statehood. Every new State that came into the Union required a transition period to establish its own government.

It is also needed because the Federal Government has to make a transition in terms of administration. It is a very complex issue, after so many years when Puerto Rico has been treated as a foreign country in terms of fiscal and economic matters, that at this time it is cut off immediately. We need a transition period that is reasonable.

We had asked for a longer period of time in our initial request to the Energy Committee, like 10 or 15 years initially for 936. Unfortunately, it was cut down, and we think we need more.

Senator PRYOR. Let me ask this: What would happen in Puerto Rico, notwithstanding the issue of the three options we are talking about this morning, if we would immediately terminate section 936, just repeal it? What happens? Say you go back Monday morning and there is no longer a section 936?

Mr. NEGRON. I can answer that from the point of view of independence. The situation would be that companies established in Puerto Rico who are subsidiaries of U.S. companies would be able to defer their income tax liability in the United States for that Puerto Rico-source income until that income was repatriated back to the United States. So there would be a deferral incentive for establishing in Puerto Rico. But additionally, a foreign tax credit would be allowed on whatever tax liability was due in the United States on that income, corresponding to the amount of income taxes paid by those companies in Puerto Rico. So, for instance, if Puerto Rico levied a 34-percent corporate tax on that income, and 34 percent being the top corporate tax rate in the United States, then no tax would be due in the United States

What we could do would be to, in effect, try to use the revenues that we would be getting by actually being forced to levy corporate taxes upon those corporations to in effect return them, somehow, to those companies by means of subsidies or financing or infrastructural investments, as long as those expenditures meet some uniformity elements so as not to trigger any countervailing measures under U.S. trade law, particularly the Tariff Act.

But we think we could offer a set of incentives that would somehow match those of 936, although it would be a very different set of incentives, and thereby we need a transition time to implement those new incentives.

Senator PRYOR. Are there other comments on that question?

Mr. COLORADO. Yes, right here.

Senator PRYOR. Mr. Colorado?

Mr. COLORADO. Your question was what would happen tomorrow.

Senator PRYOR. That is right.

Mr. COLORADO. Obviously, tomorrow would be under commonwealth status. Well, tomorrow, almost immediately after that decision, for example, I can say the tuna canning operations would leave Puerto Rico almost immediately. That is close to 10,000 jobs. They left the mainland already. They are there just for 936.

Now, in addition to that, we have 40,000 jobs in the textile industry, in the garment industry. We probably would lose about half of that. So we are up to a 30,000 job loss almost immediately.

Now, in the electronic area, that is a marginal industry, in electrical devices, hospital supplies. You would lose a large amount of that. It could be 20,000 more jobs.

So I can tell you that almost immediately you would lose about 50,000 jobs in Puerto Rico, within 2 or 3 years.

Now, in addition to that, I am in charge of promoting industry for Puerto Rico. Every time I promote 12,000 jobs, I end up with realizing 9,000, and I lose 6,000 every year, because the dynamic of manufacturing is such that you will lose jobs every year. It happens in the States, and it happens in Puerto Rico. So the result would be that I could not promote 12,000; I probably would not be able to promote more than 5,000 a year. So we would end up losing additional jobs every year and reducing that 50,000 jobs by a loss of 5–6,000 jobs every year.

In addition to that, and very important, it would have no positive effect in the Treasury of the United States, because we would impose taxes on the corporations that would remain in Puerto Rico. And there would be no deferral, because the companies would be taxed immediately in the United States, we would tax them, and a credit would be granted by the Federal Government. Therefore, no taxes would come to the Federal Government, we would have some taxes, but we would lose probably 50,000 jobs immediately, more every year, and the indirect jobs that are created by those companies—probably we are talking about a loss of hundreds of thousands of jobs.

Senator PRYOR. Thank you.

Mr. Carlo?

Mr. CARLO. Yes, Senator. First of all, the figure of employment created by 936 is somehow misleading. These indirect jobs that they count is really 10 percent, not 30 percent.

I also would like to add that the tax credit is really a tax-sparing in Puerto Rico. Some of the pharmaceutical companies, some of the companies that are taking a great deal of benefits, for example the pharmaceuticals of the group take 46.3 percent for all the benefits of 936 credits—it is not really a credit—and provide only 14 percent of the employment.

There are problems in 936. It has to be looked at, and it should be looked at immediately. Under statehood or under commonwealth or under independence, it has got to be dealt with.

I don't believe that industry is going to pick up and go. There are built-in safeguards for that. The Internal Revenue Code has been amended in terms of the intangibles, so that you cannot pick up intangibles or move them or sell them without paying a very high price. Probably what will happen is it will take a long time until these intangibles are no longer useful to the companies before a lot of them decide to move, and about 50 percent of the industry under 936 is based on intangible income. So a great deal of these companies will not move. To the contrary, they will remain on the Island, and the economy will be a lot stronger.

Senator PRYOR. Mr. McKee, we are going to have to conclude this panel, but make your statement.

Mr. McKEE. May I just make one statement? I think it is important to realize that statehood itself is a substitute for 936, because of the benefits that statehood brings, not in terms of payments from the Federal treasury but in terms of the overall structural difference it makes in the economy by being a State.

Senator PRYOR. Thank you.

Did I leave anyone out? Mr. Rodríguez-Orellana?

Mr. **Rodríguez-Orellana**. What I was going to suggest, sir, since you obviously have other commitments, we are in the best of disposition to answer any further specific questions. If you or your staff care to direct them to us, in writing we will be sure to respond.

Senator **Pryor**. Yes. We actually have several questions, posed not only by Chairman Bentsen but I think by other members of the committee. We are going to leave this hearing record open for a period, I think, of approximately three weeks. Because this is an issue of such magnitude, we want to be certain that each member has an opportunity to submit their questions in writing to each of our panelists today.

Senator **Pryor**. Gentlemen, we thank all of you for coming, and we appreciate your contributions to this committee meeting this morning. Thank you very much.

Panelists. Thank you, Senator.

Senator **Pryor**. We have a very distinguished panel, our final panel. We have a very rare opportunity now in the Finance Committee to hear three very distinguished attorneys, lawyers, professors.

First, Senator Fernando Martin, Vice President, Puerto Rican Independence Party, San Juan; Mr. Laurence H. Tribe, Tyler Professor of Constitutional Law, Harvard University Law School, Cambridge, Massachusetts; and Mr. Paul Gewirtz, Professor of Constitutional Law, Yale University, New Haven, Connecticut.

Senator Martin, you are representing yourself, or part of the legal profession in Puerto Rico?

Senator **Martin**. No, I am here representing the Puerto Rican Independence Party's position.

Senator **Pryor**. Well, you are on the panel with two of the finest legal minds in America.

Senator **Martin**. So I hear.

Senator **Pryor**. So, we will let you go first, and then let them summarize. How is that?

STATEMENT OF SENATOR FERNANDO MARTIN, VICE PRESIDENT, PUERTO RICAN INDEPENDENCE PARTY, SAN JUAN, PR

Senator **Martin**. Mr. Chairman, today I will not be testifying as to the constitutional implications under the Uniformity Clause of a transition towards statehood, because I believe that that is a position at this point essentially of advocacy, and I think that it is altogether proper that those who represent the commonwealth or the statehood position put forward their arguments as to those problems. As far as we are concerned, that is not pertinent to our proposals before this committee, and of course I wouldn't dare to testify as an alleged "expert," because after all I am a party in interest.

What I would like to address, and add my comments very briefly to, was a request by the committee staff when we met last week, in which they wanted our opinions concerning the self-executing nature of S. 712.

As to that, let me first of all point out that I find no constitutional problems whatsoever in the fact that the legislation attempts that whatever decision is chosen by the people of Puerto Rico represent a firm commitment on the part of the Commonwealth to in effect grant that solution.

Of course, it is true that a future Congress, even before the plebiscite, could revoke this law; but, so long as the law stands and the plebiscite takes place under that law, I seem to find no constitutional problems there.

What I would like to make clear, however, is that my party is absolutely convinced that when this process eventually ends, if it ever does, the Congress of the United States will not approve a bill for a referendum in Puerto Rico that contains a clause that will make it self-executing. We are convinced that the Congress will not politically approve legislation that will make statehood automatic merely because a majority of the people of Puerto Rico should so decide. That is not a legal judgment, that is a political judgment.

The principal reason why we have supported the self-executing language is because I believe it is very important that this process call the bluff on that attitude. I think it will be very important for the people of Puerto Rico to realize that the Congress of the United States is not willing to grant statehood to Puerto Rico merely because a majority of the Puerto Ricans so decide.

In fact, as an independence advocate, I am convinced that statehood in the case of Puerto Rico could never be a legitimate option for the Puerto Rican people unless it was an option chosen in the exercise of our sovereignty. Puerto Rico not being a sovereign nation, any attempt on the part of the United States to annex Puerto Rico as a State would obviously have to recognize that that does not mean the extinguishing of Puerto Rico's inalienable right to independence and self-determination; the is, in effect, its right to secede if it ever were annexed as a State, without that choice having been made by the people of Puerto Rico under the exercise of their full sovereignty.

So I have the hope that this demand for a self-executing process will serve to call what I believe is a bluff, and that all parties will be well-served at the end of this process by learning that statehood is not in the cards for Puerto Rico.

Thank you very much, sir.

Senator **Pryor**. Thank you, Senator Martin.

Professor Tribe?

STATEMENT OF LAURENCE H. TRIBE, TYLER PROFESSOR OF CONSTITUTIONAL LAW, HARVARD UNIVERSITY LAW SCHOOL, CAMBRIDGE, MA

Professor **Tribe**. Thank you, Senator Pryor.

Senator **Pryor**. This is selfish, but let me say I have long wanted to hear these two gentlemen debate, so I am going to allow 10 minutes on each side. [Laughter.]

I am going to relish this.

Professor **Tribe**. Thank you, Senator.

I am here really in two capacities. I am here as a constitutional scholar, primarily. It is true that I have been retained by the Commonwealth of Puerto Rico, but I made it very clear to the Commonwealth, at some disappointment on their part, that if I didn't as a scholar agree with a position they wanted me to advance, I would not advance it. So I am really not being an advocate, and they changed a number of positions that they took because of constitutional concerns that I raised.

Those concerns, on this occasion, I think are extremely serious. They are so serious that I think much of the discussion that you have heard about whether or not this is an even playing field may prove to be beside the point, because what some describe as a "playing field" really appears to me, Senator, to be more like a gambling casino. There is an enormous gamble—and I really want to underscore how serious and grave I think it is—that the Congress of the United States would be asking the people of the Commonwealth of Puerto Rico and indeed all of the people of the United States to take, if it were to pass S. 712 in the form that it came from the Energy Committee.

The reason is that, in my judgment, S. 712 is extraordinarily vulnerable to Federal judicial attack. Indeed, the entire referendum, because of the vulnerability that I will describe, might well be subject to an attempted injunction. The reason, quite simply, is that the statehood provisions of the bill violate some very clear language in the Constitution of the United States. Specifically, they violate the Uniformity Clause, that requires that certain taxes be uniform throughout the United States of America.

Now, as the Senator will see in the more elaborate prepared statement that I have submitted, I have suggested a number of entirely practical solutions to the transition problem that, as the Department of Justice testified earlier in the person of Assistant Attorney General Peterson, seem to raise no problems. That is, Chairman Bentsen asked the Assistant Attorney General, "Couldn't we eliminate the constitutional cloud over S. 712 by phasing in statehood—that is, by delaying the effective date of statehood until after the tax preferences had been phased out, rather than gambling with immediate statehood, followed by 6½ years of tax preferences?" And the Assistant Attorney General made clear that (1) that would of course be constitutional, and (2) she had no problem with that.

But of course that would not be nearly as appealing politically. It is appealing to tell people, "You can become a State of the Union, and even though you will be a State, you will be able, despite the Uniformity Clause, to obtain, for 6½ years, preferential tax treatment." It is quite a deal. I understand why someone might want to offer it; but, as I am going to explain, it is not a deal that is meaningfully enforceable. The reason is that the Uniformity Clause quite clearly requires that no distinction be made in the tax laws of the United States between one State and another, in specific political terms. That is, you can make geographic distinctions; you can distinguish based on whether oil is above or below a certain parallel; but the Supreme Court of the United States in its most recent pronouncement on the subject in the *Ptasynski* case made quite clear that political, as opposed to geographical, preferences are not consistent with the purposes of that clause.

The most important concession that I think has been made by the Administration here today is that, if the tax preference contained in this provision were permanent, it would probably be unconstitutional. Now, I want to underscore that: if it were permanent, it would probably be unconstitutional—so what we are really debating about is whether, by phasing it out after 6½ years, one can, in effect, temporarily suspend the Uniformity Clause.

It is important to recognize that that is the issue, because the Administration isn't the only authority that takes that position. The primary authority relied on by Mr. Gewirtz was the late Alexander Bickel of Yale, made clear in the statement from Mr. Bickel appended to the Gewirtz testimony. In his view, if the tax preference for Puerto Rico were permanent, then it would probably be unconstitutional.

The question then is, can one solve the problem by phasing it out? In my judgment, the reason one cannot solve the problem by phasing it out is that, fundamentally, doing that would run afoul of the other important constitutional doctrine involved here, the Equal Footing Doctrine; that is, the Supreme Court made very clear in the *Coyle* case, involving Oklahoma, that if something would be unconstitutional to do as among existing States, on a permanent basis, then doing it as an aspect of admitting a new State into the Union, on a different footing from the other States, is also unconstitutional.

It is important to recognize that principle, because what it means is that any suggestion that the 6½-year feature of this law would save it is a particularly risky gamble. Saying that this is just a temporary violation, in effect, of the Uniformity Clause is a little like saying that a woman isn't pregnant because her condition will be phased out in 9 months—it is just temporary.

There either is a violation of the Uniformity Clause, or there is not. If 6½ years would comply with the Constitution, why not 10 years? Why not 20 years? The principle is what counts in dealing with the Uniformity Clause. And when the Administration witnesses earlier today admitted that they were not reading the Uniformity Clause literally, and were asked by Chairman Bentsen how they could square that position with the Administration's usual preference for strict construction of the Constitution, there was an awkward silence. And I can understand why.

I can understand, Senator, why some of the portions of the Constitution—the elastic phrases, phrases dealing with liberty, equality, due process—might be interpreted in a fuzzy and elastic way. But when we are dealing with the very architecture, the structure, of the Constitution of the United States, a core provision saying that all States are to be treated in a uniform manner with respect to taxation, I don't think we can afford to bend the provisions—for 6½ years, or for 65 years.

Now, it was said by the Administration witnesses that this is not all that oppressive—it is not "oppressing" the State of Puerto Rico, if Puerto Rico should become a State. But what is important to remember is what John Marshall, the great Chief Justice, said in *McCulloch* v. *Maryland:* "The power to tax is the power to destroy." That is why the Supreme Court didn't require any showing in *McCulloch* v. *Maryland* that the Maryland tax was literally oppressing the Bank the United States; it was the principle of the thing—the camel's nose was under the tent. And if as a matter of principle the Congress were to assert that it is permissible to treat

States differently with respect to the power to tax, even for 6½ years, that would be terribly dangerous.

It is not so much the people of Puerto Rico who would complain of oppression, initially, it would be people of States like Mississippi, and there are other States—I am not sure what the economy of Arkansas is like right now, but Puerto Rico is not the only place that has economic difficulty.

There are a lot of others who would say, "Find a neutral principle. Don't draw a political boundary." And what was done with respect to Alaska oil in the *Ptasynski* case doesn't really help the constitutionality of this provision at all; the Court went out of its way in that opinion, a few years ago, to underscore that some taxes drawn along geographical lines might survive—some. And that one did, because drawing the line in terms of how far north you were was a reasonable substitute for measuring the hardship of extracting the oil. But there was not a hint in that opinion—and I re-read it again last night, at about 3:00 in the morning, but I think I was wide awake—not a hint in that opinion that suggests that the Supreme Court of the United States would sustain a provision that was drawn specifically in terms of the political boundaries of a State.

Now, of course you might say constitutional lawyers sometimes differ, and they sometimes disagree. That is certainly true. But the question really is, what would the remedy be if my suspicion—and indeed I must say, in my certitude as a scholar, that this is under a grave constitutional cloud—were to materialize?

Arthur Sutherland, a former colleague of mine who is also relied upon by Mr. Gewirtz, says, in a letter that is attached to Mr. Gewirtz's testimony, that he thinks there could well be a constitutional test in court of one of these provisions.

Now, imagine it: The people of Puerto Rico are induced to join the Union by a promise that they will get special tax benefits. That is indispensable, surely, to many who would vote for the statehood option. They are annexed.

The next thing that happens is, litigation arises. And suppose, just suppose, that I am right. I am not always right, but sometimes I am. Suppose I am right? And suppose the Supreme Court of the United States then says, "Sorry, you guessed wrong." They can't secede; the Civil War taught us that. So that the promise of tax benefits is somewhat cynical here.

It reminds me of what Justice Jackson, back in the 1940s said in the famous case regarding migrant farm workers going to California, who were promised all kinds of things. He said, "It is like a promise to the ear to be broken to the hope, like a munificent bequest in a pauper's will."

I don't think we should play Caribbean roulette with the Constitution of the United States or with the people of Puerto Rico, and I do not think it would be well-advised for the Congress to take that chance.

Thank you very much, Senator.

[The prepared statement of Mr. Tribe appears in the appendix.]

STATEMENT OF PAUL GEWIRTZ, PROFESSOR OF LAW, YALE UNIVERSITY, NEW HAVEN, CT

Professor GEWIRTZ. Thank you, Senator Pryor.

I also have submitted lengthy written testimony. But in brief, I think that Professor Tribe is really very wrong on this issue. Both the case law and a broad range of legal experts support the constitutionality of a tax transition for the new State of Puerto Rico. Indeed, Professor Tribe's arguments were made to the Senate Energy Committee, were rebutted by various witnesses, and were rejected by that committee—and I hope that this committee will reject them, too. If there are difficult issues facing Congress regarding these tax proposals, they are policy issues, not constitutional ones. The Constitution gives Congress a very free hand here to do what it thinks makes the most policy sense.

To explain why that is so, first let me supply a bit of context. History shows that Congress has very broad powers to make economic adjustments when it admits new States, and in fact, Congress has typically provided very generous economic aid and adjustments for new States when it admits them. Congress, for example, gave the State of Alaska 100 million acres of land and a large cash grant when it was admitted as a State. The typical purpose of these economic adjustments is to facilitate the transition from Territory to State, and to ensure that the new State gets off on a sound economic footing.

The tax provisions that are at issue here are part of the economic adjustments that S. 712 makes for the State of Puerto Rico, and the main reasons for these tax provisions, I think, are clear: Over the years, historically, Congress has treated the Territory of Puerto Rico uniquely for tax purposes—that is the historic fact. It exempted Puerto Rico from the personal income tax and provided for the section 936 tax credit, and in light of that unique tax history, S. 712 does the reasonable thing, which is that it provides for a transition period to a new tax regime, so that the new taxes will be imposed in a gradual manner and avoid sudden disruptions to the economy of the new State.

In spite of Professor Tribe's arguments, nothing in the Uniformity Clause prevents Congress from doing that reasonable thing, indeed that necessary thing. The Uniformity Clause does not bar geographically-defined tax treatment, and you should know that there is not a single Supreme Court decision in the entire history of the country, not one, that has ever relied on the Uniformity Clause to invalidate a Congressional tax provision.

The Supreme Court's recent *Ptasynski* case—the word "Ptasynski" has probably been spoken more frequently in this room today than ever before in our history—the recent *Ptasynski* case is squarely on point, and it's an extraordinarily convincing precedent. In that case, as you may know, the crude oil windfall profits tax excluded "exempt Alaska oil" from the tax. The legislation used the word "Alaska." Alaska was specifically singled out for the exemption. And the Court unanimously—unanimously—upheld the constitutionality of doing that. The Court's opinion was written by Justice Powell, and I think lawyers would agree that a unanimous opinion written by Justice Powell is as good as gold. Justice Powell squarely rejected the claim that the Uniformity Clause bars the State-specific exemption for Alaska oil. What he said, in essence, was that a geographically-based tax is constitutional if it deals with "a geographically-isolated problem." That is the key phrase in the opinion, "a geographically-isolated problem." And the Court was extremely deferential to Congress's judgment that in that case there was a geographically-isolated problem that justified exempting Alaska oil.

Just as Congress had ample basis for concluding that Alaska's unique problems justified special tax treatment under the Windfall Profits Act, Congress surely would have an ample basis for concluding that the temporary special tax treatment of Puerto Rico would address "a geographically-isolated problem,"—that critical phrase—namely, the fact that Puerto Rico's economy has developed around a long history of geographically special tax treatment. Indeed, the special tax treatment provided in S. 712 is, if anything, I think, easier to justify than *Ptasynski*, because the special tax treatment in S. 712 is only temporary and transitional, arising as part of the admission of a new State.

Now, my point here is not that Congress's power to admit new States somehow gives Congress the power to create an exception to the Uniformity Clause, or anything like that, which is how Professor Tribe has characterized my argument. The point here is that the context of admitting a new State creates the particular justification for a geographically-based tax treatment here—namely, that the Territory of Puerto Rico has long operated under a unique Federal tax regime, and Puerto Rico's admission as a State and its resulting movement to a new tax regime creates a unique problem, a unique problem of getting from here to there, a problem that no other State of the Union has.

Professor Tribe talks about the special tax treatment of S. 712 totally without regard to Puerto Rico's tax history and the geographically-unique problem it now presents. And he speaks of it as if the tax provisions in S. 712 are a new benefit to Puerto Rico, whereas they simply constitute a reasonable phase-out of an existing regime.

Coyle v. *Smith*, on which Professor Tribe now puts such great weight, simply doesn't help his case at all. Professor Tribe wrongly interprets *Coyle* to require that a newly admitted State be treated exactly the same as existing States. Well, if that were true, Congress's longstanding practice of singling out new States for particular land grants, cash grants, things of that sort would all be unconstitutional.

But *Coyle* is not a broad grant of equal treatment. What *Coyle* does is prohibit Congress from making substantive intrusions on the sovereignty of newly-admitted States, as Congress tried to do in *Coyle* itself, when it directed where Oklahoma's State Capital would be. Well, obviously a transitional tax exemption for Puerto Rico does not violate the sovereignty rights of Puerto Rico or, for that matter, of anyone else.

Finally, I want to underscore that I think Professor Tribe stands virtually alone in his rigid reading of the Uniformity Clause. I emphasize that because Professor Tribe says, "Well, even if you don't agree with me, there is this serious risk that Professor Gewirtz may be wrong, and a serious risk of a Uniformity Clause problem." Well, I think that is not the case, and what demonstrates this is that Professor Tribe's conclusions are at odds not only with my own conclusions but with the conclusions reached by a really extraordinary range of scholars and lawyers. And I will just briefly mention a few examples:

Professor Alexander Bickel, late professor the Yale Law School and surely one of this country's greatest constitutional scholars, wrote a long legal opinion on this question some years ago, and agreed that "temporary, transitional adjustments"—and I am quoting—in the application of the tax laws to Puerto Rico "could constitutionally be made." I've included his opinion letter as an attachment at the back of my testimony.

Professor Arthur Sutherland of Harvard Law School reached the same conclusion. (His opinion letter is also attached.)

More recently the Senate Energy Committee, which heard from Professor Tribe about this issue on at least two separate occasions, concluded that transitional tax treatment for Puerto Rico is constitutional.

The Department of Justice this morning reaffirmed the same position.

The Library of Congress's Congressional Research Service has prepared a memorandum agreeing with our position, which is in the record.

The Supreme Court's decision in the *Ptasynski* case, while obviously not addressing the specific question here, was unanimous in reaffirming an extremely deferential approach to Congress in evaluating geographically-specific tax statutes, an approach altogether at odds with the rigid one that Professor Tribe takes.

And finally, I want to emphasize again that no Supreme Court decision in the entire history of our country has ever struck down a Congressional statute on Uniformity Clause grounds.

Obviously this committee must make its own judgment about the tax provisions of S. 712; but I urge you to disregard Professor Tribe's lonely objections to the constitutionality of these provisions. The overwhelming weight of opinion is against him, and, this time at least, he is simply wrong.

Thank you.

[The prepared statement of Professor Gewirtz appears in the appendix.]

Senator PRYOR. Thank you, Professor. This has been a most fascinating meeting.

Now, I am going to assume that Professor Tribe may want to rebut you for about 3 minutes.

Professor TRIBE. I think it is a fair assumption, Senator. [Laughter.]

If I do stand alone, I feel in good company, with the language of the Constitution. But the parade that we have heard here of supposed authorities who agree with Mr. Gewirtz is simply false.

I read the Bickel attachment, and I was tempted to say—I guess if Senator Bentsen had been here it would have made some sense—I was tempted to say, "I knew Alex Bickel." True. "Alex Bickel was a friend of mine." [Laughter.]

Alex Bickel never said that you could give a political exemption to Puerto Rico.

Senator PRYOR. Am I supposed to say you are not an Alex Bickel? Am I supposed to say that? [Laughter.]

Professor TRIBE. No, I think we will just assume it.

Senator PRYOR. I don't think Senator Bentsen would have, either.

Professor TRIBE. I don't know. But the point is that Professor Bickel was talking about a grandfather clause; he specifically said if you take companies that were doing business in Puerto Rico as of a certain date, and take time to phase them out, that is perhaps all right. That is totally different from saying that for 6½ years—and that is at page 5 of his statement, Paul—that for 6½years any company that comes into Puerto Rico, or any person who is a resident of Puerto Rico, gets special tax treatment.

Now, it is true that the Court has never struck anything down under the Uniformity Clause. That is like saying they have never struck down anything under the clause saying that the President has got to be 35 years old. The clause works. It doesn't spawn a lot of litigation, because it is so clear; and it is so clear that I am amazed that Mr. Gewirtz can misread the *Ptasynski* case the way he does.

Let me quote for you from one page of *Ptasynski:* "Although the Act refers to this oil as exempt Alaskan oil, the reference is not entirely accurate." The Court points out that only 5.1 percent of the oil in Alaska was exempt Alaska oil, and that the special reason for the law was that almost 83 percent of the oil in Alaska was subject to the Windfall Profits Tax and didn't get an offset because, as I understand it, it is awfully cold up there.

So there is not a word in *Ptasynski* that supports this rather unique theory that we have heard today.

A couple of other points:

We are told that Congress has broad powers of economic adjustment for new States. That is exactly my point. It has those powers. It can use them constitutionally. It can give special grants, on-budget, to new States, and there is nothing in the Constitution that forbids that.

Mr. Gewirtz says that Puerto has been treated uniquely over the years. That, too, is exactly my point; it has never been a State before.

It is then said by Mr. Gewirtz that the *Coyle* case doesn't mean new States must be treated the same as old States. Of course not. I re-read *Coyle* again last night, too. The *Coyle* case doesn't say that, and I never suggested it did. What the *Coyle* case holds is that, if something could not constitutionally be done, as among old States, there is no "junior varsity" among the States—there is no way of letting some States in and saying, "For a while we will do this to you, or for you." And any suggestion that you can draw a principled line between a benefit and a burden here is a snare and a delusion.

So I do submit that the gamble that Mr. Gewirtz asks you to take would leave not me standing alone but the people of Puerto Rico, who would be given no redress.

Thank you.

Senator PRYOR. Thank you, Professor.

Professor Gewirtz?

Professor **Gewirtz**. Well, just a few quick points.

I attached the Bickel letter to any testimony precisely so that the committee could read it for itself and reach its own conclusions about whose reading of Professor Bickel is accurate, and I urge you to do so.

Second, since the *Ptasynski* case is obviously devastating to his position, Professor Tribe seems to be arguing that the tax statute in *Ptasynski* was really not State-specific. Again, I urge you to read the opinion. The legislation uses the word "Alaska," and while it is true that not all of the oil in Alaska was exempt (only some of it was) and while it is true that the exemption also included some oil outside any of the territory of the United States, neither fact detracts in the slightest from the reality that the exemption was drawn on geographic lines, using "State-specific" language in the drafting of the legislation. And it was precisely this state-specific geographic line that the Court upheld once it had identified that Congress in its good-faith judgment had identified a geographically-isolated problem.

Finally, while I cannot urge this committee to stay up as late as Professor Tribe did to read the *Coyle* case, if I simply tell you what was involved in that case I think you will conclude that it has no real bearing on the matter here. What Congress did in *Coyle* was direct the State of Oklahoma where its State Capital had to be, and all that *Coyle* says is that Congress may not interfere with the sovereignty of a new State in a way that it could not interfere with the sovereignty of other States. No provision of S. 712 interferes with the sovereignty of Puerto Rico or any other State.

Finally, I repeat the point on which I ended my main testimony, which is that independent experts from the Justice Department, the Congressional Research Service, the Energy Committee and elsewhere have reached a conclusion totally at odds with that of Professor Tribe's. So you are not simply hearing a debate between Harvard and Yale. You are hearing two positions that many others have evaluated, and there is overwhelming agreement with the position I am urging to you today.

Senator **Pryor**. Well, Professor, this has been a classic debate. I wish all of the members of the committee could have had the privilege of listening to this discussion.

Because I think some day someone will read this record, I would like just to place in the record Article I, section 8, clause 1 of the U.S. Constitution, the Uniformity Clause. And I quote, "The Congress shall have the power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, impost and excises shall be uniform throughout the United States." This is the discussion with which you two very distinguished professors have been involved and here during the better portion of this past hour.

I would like to ask the two of you—and this is not a legal question, but in your research involving this issue of Puerto Rico—have you noted anything that the Congress or our government did in the cases of the admission of Alaska or Hawaii that were unique, that was (1) either a detriment to either of those States, or (2) a favor to either of those States?

Professor **Tribe**. Senator, there are two aspects of the Alaska and Hawaii experience, that I think are relevant to your question, that I have come across:

One relates to the experience with respect to the Federal Transportation Tax. There was a period prior to the entry into the Union of Hawaii and Alaska as States, in the early part of 1959, when the transportation tax operated to the distinct disadvantage of those jurisdictions, because other Caribbean locations were exempt while Hawaii wasn't—other Pacific locations were exempt, and so on—and in order to prevent the disadvantage from persisting, an exception, subject-matter based, was made to the transportation tax.

Now, I don't know how well it worked out for Alaska or Hawaii, but I do know that the scholars on whom Mr. Gewirtz relies have expressed some doubt about the constitutionality of those very exemptions. They have never been tested in litigation, and I would submit that an income tax preference is even more vulnerable.

The other thing that is quite interesting and noteworthy about the Alaska and Hawaii situations is that, as far as I can tell, those are the only two States that have ever been admitted to the Union by Federal legislation which became self-executing upon a presidential proclamation following a referendum in the States themselves, in some way similar to what is proposed here. And I gave some thought to the question of whether that means that the self-executing aspect, to which several earlier witnesses have referred, therefore raises no constitutional problem.

After all, far be it from anyone who loves to travel to Alaska and Hawaii to suggest that they are not constitutional members of this Union. I don't doubt that their membership is constitutional, and yet there is this problem.

The problem is that there is no serious Supreme Court precedent suggesting that Congress really has the power to abdicate to the people of a territory or of a commonwealth the deliberate decision, based on all the relevant facts, whether that area should join the Union.

Even in the cases of Alaska and Hawaii, the people were not given a multiple-choice exam—"Independence? Commonwealth? Enhanced Commonwealth? Statehood?"—it was an up-or-down vote for statehood. There wasn't much contingency involved. So Congress knew exactly what it was doing when it invited those jurisdictions, by vote, into the Union.

There is a kind of sleight of hand going on, I think, in S. 712 when it comes to statehood. Congress, in effect, is holding out the carrot of statehood as one option, dangling along with it some other vegetables like the special tax privileges that, if I am right, would be invalidated. But it is not doing that, confident that that is what the people will choose. That is, Congress is deciding, in a purely hypothetical way, that it wants Puerto Rico to be a State of the Union.

Now, whether a court would agree that putting in effect a hypothetical question of that sort is really appropriate legislation, I am not sure. I suspect that it would never be litigated. I suspect that this is one of those things that would lead future scholars to debate about whether this State had been legitimately admitted. But that is all the more reason that Congress should ask itself: "Is it a constitutionally appropriate exercise of power, in effect to legislate in contingency to the degree of purely hypothetical guessing?" I mean, if, for example, Congress were to say that the people of Puerto Rico get 25 options, and one of them is statehood, and if that one gets more votes than any of the others, then it becomes a State, many people in Congress who voted for that would never have, in effect, voted for statehood; and yet, that is what would happen upon presidential proclamation.

So I don't think it would be struck down, but I think it raises a doubt for Congress as a matter of constitutional propriety.

Senator PRYOR. Thank you, Professor Tribe.

Professor GEWIRTZ. A few comments. First, one of the lessons from Alaska is how generous Congress can be when it admits a new State. Alaska received, as I mentioned, 100 million acres of land when it became a State, as well as millions of dollars in direct cash grants.

In addition, there are a couple of other interesting things that were associated with Alaska's admission. One of them is that Alaska was singled out to receive 90 percent of the revenues earned from the leasing of Federal mineral lands which were located in the State, whereas all other States only received 50 percent of comparable lease revenues, suggesting, once again, the way in which during the admission process States are treated differently from each other.

Senator PRYOR. Was this decision during the process of admission, or after it?

Professor GEWIRTZ. Yes, it was part of the Enabling Act, and in fact I cite that provision on page 3 of my testimony.

Third, Professor Tribe mentioned another thing which I discussed in my written testimony, on page 9, which is a Congressional precedent for State-specific tax exemptions, which I think should be very instructive about what Members of Congress think the Uniformity Clause means and does not mean.

As part of the admissions process for Alaska and Hawaii, Congress continued indefinitely the exemption from the transportation tax law that those two States had enjoyed as territories, and that exemption remains in force today. The reason, once again, was that Congress had identified a geographically-isolated problem, which was the remoteness of Alaska and Hawaii in this instance, and used that as a basis for a geographic and State-specific tax exemption.

Professor Tribe raised the issue of the self-executing, nature of the plebiscite, and maybe I should use this opportunity to say a few things to supplement his comments on that and, I suppose not to disappoint anyone, also to disagree with the drift of some of his comments.

The question of whether the procedure used in S. 712 case is at all problematic can be thought about, first, by realizing the extraordinary diversity of ways by which new States have been admitted to the Union. There is no set pattern. There are instances where prospective States have already elected Senators who have come to Washington and have basically lobbied their way in; and there are an enormous variety of referendum-type procedures which Congress has used in the past. Nothing in the text of the

Constitution seems to control the ways in which Congress may choose to admit States. The language that Senator Pryor quoted is obviously very general and non-specific.

But there are more precedents for what I would call a self-executing process of admission than Professor Tribe was suggesting. Let me say immediately that there is no precedent that I know of that quite fits this one, in the sense of a situation in which there are a range of status options, like independence, commonwealth, statehood. But are there congressional precedents for statehood admissions that are "self-executing," in the sense that Congress had only one look at the statehood question and, in advance of a vote by the people in the territory, Congress stated the terms and conditions on which it would admit a State? The answer is definitely yes, and the examples are far more numerous than the ones Professor Tribe mentions.

I don't have a list with me, but my recollection is that South Dakota, North Dakota, Oklahoma, perhaps Montana, and several others were admitted by means of a process where Congress actually passed a bill that provided a whole series of requirements for statehood, land grants should statehood be approved, and even fallbacks should statehood not be approved—things of that sort—and that was it. And in the event, of course, the people voted to become a State. So there certainly is ample precedent for statehood plebiscites that I would call "self-executing" in the sense that they involve one look by Congress, in advance of a vote by the people, and one look in which Congress both contemplates the possibility that the people may turn down statehood and also accepts statehood in advance if the people approve it.

Professor TRIBE. Senator, might I add just a word? It seems to me that Alaska and Hawaii are very instructive at a broader and less technical level. Just think about what it means to have a special transportation tax exemption for these two States; that is, they are uniquely, at least as of now, the States that are not continentally attached to the United States, non-contiguous.

A uniformity principle can fairly easily be reconciled with the idea that, if you are traveling across the ocean to another State, it is a different situation. But what is supposedly different about Puerto Rico in this respect is that it has got a tough economic go of it. That is important, but it is not unique to Puerto Rico.

The other important thing to remember is that, when examples are given of how Congress can tailor an admissions process to the problems of a State—it can give the State land, it can give it money—the point that is being made is really the point I want to make, and that is, you don't need to play fast and loose with the Constitution if you are willing to go on-budget and be visible about what you are doing for a State. It is always very appealing to sneak things in through the Internal Revenue Code, because it doesn't contribute to the problem of a conspicuous expenditure, a line-item expenditure. And that is why taxation is different. And that is why it is very important to recognize that it is not as though the government owns everything and then just deigns not to tax some of it. There is a big difference between the taxation power and the spending power, and because of that difference, what Congress is being asked to do here is really quite extraordinary and potentially dangerous, and quite a gamble.

Senator PRYOR. Professor Tribe, thank you.

Professor GEWIRTZ. May I just make two very brief comments?

Senator PRYOR. Yes. I am going to have to leave here in about one minute.

Professor GEWIRTZ. Two very brief comments: First, Governor Romero just came over to me and reminded me, and asked me to mention, that Puerto Rico would be the first territory admitted as a State since the adoption of the Federal Income Tax which was not paying tax at the time of admission. So if you ask whether there a geographically-unique problem, that the tax transition features of the bill is trying to address here, the answer is clearly yes.

Second, I just wanted to mention to the Senator one of the themes that Senator Johnston reiterated during the Senate Energy Committee deliberations, as it bears on this issue of a self-executing plebiscite. Senator Johnston repeatedly said during those hearings that he thought it was important for the people of Puerto Rico to know what they were voting for, and, before a bill as detailed as 712 is adopted, for Congress to face up to those issues in advance, so that the people could make informed choices.

While I recognize the difficulties that such a detailed piece of legislation poses for Congress, I think Senator Johnston was right, that the people of Puerto Rico deserve to know what the implications will be for their lives under the various options.

As one of the witnesses this morning said—I think it was Kenneth Gideon—of course it remains for Congress, after such a vote, to adopt more detailed, omnibus, transition-type rules. But I do think Senator Johnston is correct, that it is important to proceed in the way that S. 712 does proceed.

Senator PRYOR. Professor, thank you.

We thank both of you. One, we are going to leave the record open for three weeks. There are several questions. I have several, for example, that Senator Bentsen wanted to pose to each of you. I assume those will be done in writing.

Second, Senator Bentsen also, through his staff, has advised me that he is extremely interested in the provision of S. 712 of the self-executing nature of this so-called arrangement or process, and anything that either of you would care to submit in writing on this issue would be very much appreciated by the Chairman and by the members of the committee.

Senator PRYOR. Well, the debate on these three options will continue tomorrow at 10:00 in this same room. At that time, we will take two more aspects of Puerto Rico debate. Social Security and the trade.

We want to thank our panel once again, and all of you, for being a part of this hearing.

WITNESSES. Thank you, Senator.

[Whereupon, at 1:09 p.m., the hearing was recessed, to be continued Wednesday, November 15, 1989, at 10:00 a.m.]

PUERTO RICO'S POLITICAL STATUS

WEDNESDAY, NOVEMBER 15, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was reconvened from November 14, 1989, pursuant to notice, at 10:10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senator Moynihan.

[Background materials on the Costs of the Puerto Rico Status Referendum Act and Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status appears in the appendix.]

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order.

Today we conclude the opening set of hearings on S. 712, a bill to establish a referendum for the people of Puerto Rico, to decide whether or not they want to continue as a commonwealth, become the 51st State, or become an independent nation.

Yesterday we addressed primarily questions of tax policy in this status legislation. Today we will deal with the problems of international trade and the major social welfare programs within the jurisdiction of the Committee on Finance.

Those programs are: Social Security, Medicare and Medicaid, Aid to Families with Dependent children, and the employment and training component, the Jobs Program, Supplemental Security Income for the needy, aged, blind, and disabled, the Social Services Block Grant, and the Unemployment Compensation Program.

Obviously, during this particular hearing we will not be able to fully examine all of the detailed changes that may be needed in each of these programs to accommodate a change in political status in Puerto Rico.

As I recall, some of the witnesses yesterday said we shouldn't go into great detail in trying to bring this about, insofar as what those changes would be, and I concur with that.

I hope, however, that today's witnesses can give the committee a basic understanding of the scope of the changes that we need to consider:

How they are or are not appropriate to the economic and social conditions of Puerto Rico, How they should be structured to provide an even-handed choice among the three status options,

What they mean to the taxpayers of this country, insofar as our budgetary realities for the problems that we are facing in this nation.

I defer to the distinguished Senator from New York, for such comments as he might want to make.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I would like to thank you for getting this process going. It is a process that has been underway for a generation now, from the time of the great efforts under President Kennedy to resume the relationship that had so last from the time of Guy Rexy Tugwells, during the 1930s under President Roosevelt, and a lot of us have got to know each other pretty well over the years.

One large intervening event in the relations between the United States and Puerto Rico in the last generation—it is the one that we will be discussing here, and with obviously complex concerns, as Congressman Fuster would agree—is that we have put in place in a generation a whole range of social programs which turn primarily on income and are measured by a poverty line, a rather simple device which was hit upon overnight in the mid-1960s. It is a number that is three times the number of a basic food basket developed by the Department of Agriculture about 50 years ago. And all manner of qualifications and entitlement arise from dollar-income measured in that manner.

The simple fact is that where about 11 percent of American families are below the poverty line, and become so entitled, the majority of Puerto Rican families are. And from that simple fact flows an enormous range of entitlement of a kind that obviously would change a society, in which they are available. It would be different from present Puerto Rico, different from anywhere in the world, unlike anything that has been known.

In that sense, Mr. Chairman, earlier in the year we asked the Congressional Service to give us an assessment of what these impacts would be, and characteristically they did the job very well. Ms. Carolyn Merck, who supervised the study, will be here this morning on a panel, reporting.

I would simply like to say to the committee that this information is at hand and I think will be found of great interest.

Thank you.

The CHAIRMAN. I should say to my friend from New York, I have had some association with the transition of Puerto Rico for some time. Back in 1950 I participated in the enactment of Public Law 600, and that was unique in the way a territory was handled, in that it let the people of Puerto Rico evolve a constitution of their own, to help on self-government.

I also recall being down there and speaking to their legislative body in about 1952 or 1953, as I recall, and the change that took place there at that time, I remember, was not without some violence. I much prefer this process.

I recall the nationalist movement then, the violence that erupted. I happened to have been on the floor of the House of Representatives at that time and had just made a speech. I don't think I instigated what erupted, but it was a pretty exciting moment. I recall President Truman stuck his head out of the window of the Blair House, and somebody told him he'd better pull it back. But this process I much prefer, and the evolution that is taking place.

Puerto Rico has done relatively well, as compared to its neighbors that surround it, with a standard of living and per-capita income substantially above theirs, but not yet up to that of the Mainland. And trying to improve and continue to improve the lot of the people of Puerto Rico is what this is all about. The argument is, which avenue, and which option is best?

You have three very able leaders of three different political movements in Puerto Rico. Yesterday they made their points, and I am sure they have been well publicized back in Puerto Rico, but to let that finally be the decision of the people of Puerto Rico is the objective of this piece of legislation.

As the first witness this morning, we have the United States Representative from Puerto Rico, Hon. Jaime Fuster.

We are delighted to have you.

STATEMENT OF HON. JAIME B. FUSTER, A U.S. REPRESENTATIVE, RESIDENT COMMISSIONER, COMMONWEALTH OF PUERTO RICO

Congressman Fuster. Mr. Chairman, Senator Moynihan, in the brief time I have, I want to raise just one issue regarding the scope of the changes that will come about as a result of S. 712, one issue regarding Federal expenditures that I think this committee must address.

A vital question at issue as we approach the referendum is the potential cost to the United States Treasury of statehood for Puerto Rico.

The Senate Energy and Natural Resources Committee, in its committee report, signals its expectation, and I quote, "that both spending and revenue estimates will be refined as the bill moves forward in the legislative process." Well, as you know, already the Congressional Budget Office has produced, on November 6, itemized estimates of expected spending increases under statehood, which differ radically from those of the Energy Committee's report. The cumulative difference, by the way, in the two estimates, the one of CBO and the one of the Senate Energy Committee report, is $5.711 billion, what I would consider a very significant sum.

However—and this is the first point I want to make—even CBO's very broad assessment is not yet complete. For one, the CBO assessment does not take into account an added cost that the Congressional Research Service has identified for us. Senator Moynihan, it is not even in their own report which you mentioned; it is an additional estimate they have communicated to us, over and above what they have put in the report they prepared at your request. I refer to an additional $108 million, yearly, which Puerto Rico would have received in Title I allocation funds if we had been a State of the Union. Using the 5-percent inflation rate that the

Energy Committee's report used, this adds another $538 million to the cumulative underestimate of the committee report.

Important as this is, however, there is another vital aspect not covered in the committee report, or in the CBO analysis, or in the Congressional Research Service analysis, and I refer to the potential effect of statehood on the economy of Puerto Rico.

I believe that any reasonable assessment of Federal budgetary costs of statehood must address the fundamental question of what would happen to Puerto Rico's economy upon the advent of statehood. This is because a very credible case can be made that statehood would so disrupt the Island's economy that, inevitably, Federal transfer payments to the Island would have to be substantially increased to avoid economic disaster.

As I have mentioned, this issue has not been examined at all by the various agencies and all congressional committees studying the potential effect of Puerto Rican statehood upon the Federal budget.

Studies have been made about additional Federal expenditures that would be required under the statehood option, in giving Puerto Rico equal footing with the rest of the 50 States regarding Federal benefits, but they have all assumed that there would be no other change in the Island's economy; they all assume that all existing needs in Puerto Rico—for nutritional assistance, health care, college loans and scholarships, unemployment benefits, and so forth—will remain the same under statehood. Such assumptions may be grossly unwarranted.

Puerto Rico's economy today is built around its exemption from Federal taxes, an exemption that would be precipitously ended by the advent of statehood. The elimination of Federal tax exemption would have at least three major effects upon the Island's economy:

First, it would deprive the local government of most of the funds it now has, largely diminishing its role as the main support of the Puerto Rican economy. Exemption from Federal taxes has permitted Puerto Rico to support a large public sector providing vital public services and employing more than a third of the work force in the Island. Financing for this huge public sector comes mainly from Puerto Rico income taxes, which are higher than Federal income taxes, and local excise taxes, which are higher than most State sales taxes.

It is estimated that the removal of Federal tax exemption under statehood could deprive the local government of 60 percent of its current revenues, with no new Federal expenditures to compensate for this particular loss, causing, therefore, the removal from the Island's economy of hundreds of millions of dollars in services, jobs, and capital investments.

Second, as was discussed yesterday, the removal of Federal tax exemption would be a grave blow to the cornerstone of the private sector, section 936 of the Internal Revenue Code. About three-fourths of all manufacturing employment in Puerto Rico is in 936 companies. Moreover, 936 deposits in Puerto Rican banks have allowed the financial sector to grow and thrive to unprecedented levels.

Together, manufacturing and banking, and the indirect service jobs they create, account for close to a third of the Island's labor force. Here again, the elimination of Federal tax exemption will inevitably result in a sharp decline of the existing manufacturing and financial structure, with the loss of thousands of jobs and the removal of hundreds of millions of dollars from the productive sector of the Island's economy.

Finally, the removal of the Federal tax exemption under statehood would be a severe blow to the construction industry in Puerto Rico. Both housing developments and the construction of hospitals, industrial plants, hotels, and other infrastructure, are made largely possible in Puerto Rico through financial instruments that depend on local and Federal tax exemption. Here again, the loss of local tax autonomy which would accompany statehood would be a severe blow to the financing of construction in Puerto Rico, causing a serious decline in jobs in this sector and the removal of hundreds of millions of dollars from the Island's economy.

It is important to note that these three major adverse effects of the removal of Federal tax exemption are separate and distinct from each other; that is, they fall upon different sectors of the Island's economy. When one considers them jointly, when one takes into account their cumulative or synergetic effect, it becomes very obvious that it may be very foolish to estimate Federal Treasury costs of statehood for Puerto Rico, without also examining the question of how the Puerto Rican economy is to survive without Federal tax exemption.

Let me, to conclude, briefly mention a second different reason why this committee should address the issue I have raised with you: No legitimate decision on the future status of the Island can be made by Puerto Ricans unless we have been well-apprised beforehand as to the economic risks we might have to assume in order to attain statehood.

Statehood is portrayed by its supporters in Puerto Rico as the panacea for the many complex and intractable social and economic problems that Puerto Rico has suffered for centuries. Puerto Ricans are being told that, with statehood, unemployment will nearly disappear, education and health care will be of the highest quality possible, our local roads will be like the best interstate highways, there will be no homeless, and even crime will diminish.

We in Puerto Rico have the right to know whether or not the United States Congress shares those alluring expectations about the bonanza that allegedly will accompany statehood. And this is so, because all of the studies that are conducted on this matter tend to show that the results will be very different.

In 1966, the congressionally-created U.S.-Puerto Rico Status Commission, headed by Senator Henry Jackson, concluded, and I quote, that "unless an appropriate substitute for Puerto Rico's present economic arrangements can be provided, it is clear that statehood . . . would have severe and probably disastrous consequences. . . . It is not helpful to the people of Puerto Rico to claim that the economic question of statehood is not potentially a very serious one." That is a quote, as I say, from Henry Jackson's committee.

Similar conclusions have been reached by the Tobin report of 1976, conducted and prepared by a Nobel Prize-winning professor of Yale University, Professor Tobin, and the 1979 Kreps report by U.S. Secretary of Commerce, Juanita Kreps. We in Puerto Rico have the right to know whether those assessments are still valid.

We each have to know what is your most considered judgment on this crucially vital matter, so the people of Puerto Rico can truly make an intelligent choice.

Thank you.

[The prepared statement of Congressman Fuster appears in the appendix.]

The CHAIRMAN. Thank you very much.

Senator Moynihan, for your comments.

Senator MOYNIHAN. Mr. Chairman, I would like to thank Mr. Fuster for his statement—our colleague and friend—and make one general and then one specific point:

Sir, you come before your colleagues here and speak in a very friendly but somewhat adversarial mode. You say, "Puerto Ricans have a right to know." Well, yes, everybody has a right to know; but what is knowable, as is knowable by you as by anybody on this board, is all objective, open information. We are not making any decisions in the Finance Committee, and there is nothing we can tell you that you don't already know or can't find out yourself.

Now, the second thing, sir, you mentioned the commission that was established by our dear friend, Mr. Chairman, and my dear friend Scoop Jackson, that reported in 1966 and said that statehood would be a "disaster"—and that was the word used. But in my opening remarks I said, since the early 1960s, when this issue revived again and Munoz and his friends were around in Washington, there have been very large changes in social provision enacted here in Washington, which, under statehood, would apply automatically to a State of Puerto Rico. I mentioned four of them, and I will just go through them very quickly:

First, the earned income tax credit would be available, based on this poverty line. Puerto Rico has the highest per-capita income in Latin America, but it is below our dollar line—the majority of families are. The earned income tax credit did not exist in 1966. Sixty-five percent of Puerto Rican families would be entitled.

The food stamp program, for practical purposes, did not exist in 1966, and when we last reviewed it in this committee, 70 percent of the population of Puerto Rico was receiving food stamps, and, if I am not mistaken, your agriculture disappeared, which it would do in any setting of that kind.

The Supplementary Security Income, which is Aid to the Aged, Blind, and Disabled did not exist in 1966, and under it, people receiving SSI would be in the ninth decile of income, next to the very highest group of income—which is fine by me; I would like to see a world in which the aged, the blind, and the halt were the best-off people in the population, but that program did not exist in 1966.

And finally, Medicaid would become available in enormously greater amounts, and that program did not exist in 1966.

All I mean to say to my friends, and my colleague and brother, and to my chairman is that the argument, as last laid down in the early 1960s, won't really get us through an analysis today.

Thank you, Mr. Chairman.

Congressman FUSTER. If I may comment on that statement, Senator, I would like to clarify one or two things.

First, let me say that when I referred to Puerto Ricans' need to know, I was not trying to present any adversarial scenario to any of this. I am just saying that the whole drift of S. 712, to define in great detail in every different matter, the alternatives. This has a very good purpose, and that is to let the people know exactly what their options are.

My only problem with that is that it is not enough, for a large and very complex population like the one in Puerto Rico, to simply tell them in a detailed fashion what the three alternatives are going to be. The implications for all of them need to be known also.

I think there are aspects of some of the economic implications of these options that have not yet been adequately studied. I think it is better that Congress study them than we, because of the objectivity or credibility factor. If we or if somebody else, other than a party, does a study like that in Puerto Rico, we are bound to be accused of doing a partisan study. But if it is done by Congress, it carries with it an objectivity that has great credibility. It is only in that sense that I meant it.

Now, as to the four programs that you mentioned, there is no question about it, but I think that my basic point is still true, notwithstanding those four new elements that you bring into the picture. And that is precisely why, in addition to citing Senator Jackson's famous study, I mentioned that studies conducted over a decade later by Professor Tobin at Yale University, and by the Commerce Department in 1979, tend to sustain the basic point that was made in Senator Jackson's study, and I think they are still valid; because, although it is true that there would be increased transfer payments to Puerto Rico under all of the programs that you mentioned, this does not address the precise problem I raised.

Let me put it this way: Puerto Rico right now has what you could call two different economies. I am sure that some people think there are more than two, but I believe there are basically two—what I call "the productive economy," and what could be called "the dependent economy."

My point is that statehood might destroy—it certainly will change—the economic arrangements that have made possible the productive economy. It might destroy that and substitute it for a much larger dependent economy.

The CHAIRMAN. Mr. Fuster, I understand your argument. There is no way that anyone in the U.S. Congress can afford you or any advocate for any one of these three options certainty as to the economic results—no way. I see a great many of economists and listen to them—I have been subjected to them—some of them, bat about 500 percent, which is just fine in baseball but, when it comes to forecasting the economy, is not particularly helpful.

I note that the estimate is—and it is an estimate only—that our own budget deficit will worsen in this country if Puerto Rico becomes a State by about $8 billion over the 4 years, because the benefits are in effect and the tax revenues are not, in equal sums. But whatever one of these three options each of you fellows support, you will present with your spin on it as to what you think it does for Puerto Rico. Each of you will be trying to sell a point of view that you think is best for Puerto Rico, and there will be no certainty in the final outcome for the people of Puerto Rico. They will have to weigh it and make their judgment, and there is no way we in the Congress can assure what the outcome will be under any one of them, any more than we can tell you what the economic outcome for this country is going to be on trade deficits, budgets, and the rest over the next 10 years. That is part of the fun of being in a democracy.

Congressman FUSTER. But, Senator, if I may make just a brief commentary on that, when the Senate Energy Committee began its studies, it had to depend on the best information that was available then, and they made some estimates. Now CBO has corrected those estimates by almost $6 billion of added expenditures. Today I mentioned to you another item that would add about $540 million additionally.

The CHAIRMAN. Mr. Fuster, every year they will get smarter as to what the results will be. [Laughter.]

Congressman FUSTER. Yesterday, the Administration itself came up with something that we had not heard before, and that is that 25 percent of the 936 industries would probably leave the Island. Right now we know that that amounts, directly or indirectly, to about 75,000 jobs. All I am pleading for is the most comprehensive analysis of these questions that can be made, knowing for sure that there are all kinds of certainties and uncertainties there.

The CHAIRMAN. You would never get through with an analysis unless you say, "We stop on Friday."

Thank you very much.

Our next witness is Mr. James Murphy, the Assistant U.S. Trade Representative for Latin America.

Mr. Murphy, we are pleased to have you here. Please proceed with your testimony.

STATEMENT OF JAMES M. MURPHY, JR., ASSISTANT U.S. TRADE REPRESENTATIVE FOR LATIN AMERICA, CARIBBEAN AND AFRICA, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Mr. MURPHY. Thank you, Mr. Chairman.

I have a statement which I would like, with your permission, to submit for the record, and provide an oral summary here at this point.

The CHAIRMAN. It will be accepted.

Mr. MURPHY. We have examined closely the three options contained in the bill, to identify the implications for U.S. trade policy. We do not, in our testimony, comment on the overall merits of any particular option.

We had the opportunity this summer to comment on an earlier version of S. 712. The current version of the bill seems to resolve most of the concerns that we had expressed at that time. The only major remaining difficulty from a trade policy perspective is the treatment of coffee. In addition, we have suggestions on two other trade-related provisions of the bill.

The first issue that concerns us is Puerto Rico's tariff on coffee.

Mr. Chairman, since 1930, Puerto Rico has been allowed to maintain its own tariff regime on coffee, despite the fact that Puerto Rico is in the Customs Territory of the United States. Using a special, congressionally-provided authority, Puerto Rico charges a duty on all coffee imports, currently at a rate of $1.40 a pound, including those imports from the United States. I would point out the

U.S. tariff on coffee is zero, and that is a rate of duty which is bound in the General Agreement on Tariffs and Trade.

The bill appears to us to be ambiguous concerning Puerto Rico's ability to impose a tariff on coffee, if it should select the option of statehood. USTR requests that Congress make an explicit determination on this issue. We believe that Puerto Rico should not be permitted to impose a tariff on coffee of its own.

We recognize that Puerto Rico's ability to levy a tariff on interstate shipments of coffee is an issue for the Congress to decide. However, as a policy matter, we believe that permitting a State to levy its own tariffs is highly undesirable and sets an unfortunate precedent. Indeed, this is the only case that we are aware of in which the Congress has authorized a State to set its own tariff, or an entity to set its own tariff, in which an entity has done so.

The **Chairman**. Well, Mr. Murphy, in Star County, Texas, the Commissioners' Court, back in about 1890, stated that the laws of the United States did not apply to them, and they levied a tax on brown sugar coming across the river, on the Rio Grande. That lasted until the Federal Government found out about it. [Laughter.]

Mr. **Murphy**. The second issue pertaining to coffee that concerns us is Puerto Rico's status under the International Coffee Agreement. Although Puerto Rico is part of the U.S. Customs territory for other purposes, it has been exempt from the requirements of the International Coffee Agreement. As a result, even when the International Coffee Agreement's export quota provisions were in effect, Puerto Rico was allowed to import coffee from members who were not members of the International Coffee Agreement.

If this situation were to continue under statehood, in the absence of a tariff, it could seriously undermine our ability to implement the import-control provisions which are required under the International Coffee Agreement when the Agreement's export quotas are in effect. As you know, Mr. Chairman, they are currently not in effect; but the President has instructed us to seek to renegotiate that agreement.

In light of these two points, we would strongly recommend that the bill be appropriately revised to reflect the following points:

First, that Congress should preferably eliminate, or at least phase out, the tariff on coffee under either statehood or commonwealth status; and

Second, that Puerto Rico, if a State, will be bound by the requirements in the International Coffee Agreement, as they apply to the United States generally, at the time Puerto Rico is admitted to the Union.

In addition to these concerns on coffee, we have suggestions on section 316 of the bill, about negotiation of the Free Trade Agreement, and designation as a beneficiary country under the Caribbean Basin Economic Recovery Act.

Section 316(b) indicates a procedure for developing specific provisions governing trade between the United States and an independent Puerto Rico. In this section, Congress expresses its willingness to consider a mutual free trade agreement. We make some suggestions in the testimony I have submitted regarding the procedure that we believe should be specified in the bill. Furthermore, since the President's authority to negotiate a free trade agreement, under section 1102(c) of the Omnibus Trade and Competitiveness Act of 1988, expires on June 1, 1993, Congress may want to specify a longer time frame in this bill for consideration of such an agreement with Puerto Rico.

Lastly, section 316(b) seems to require the President to designate Puerto Rico as a beneficiary under the Caribbean Basin Economic Recovery Act, if it meets all criteria and requirements. We believe the bill should be clarified so that the President is given the authority to designate Puerto Rico as a beneficiary under the Caribbean Basin Economic Recovery Act, rather than being required to do so, provided that Puerto Rico is found to meet all criteria for eligibility. This would be consistent, Mr. Chairman, with current provisions on designations of other CBI beneficiaries.

Also, section 212(b) of the Caribbean Basin Economic Recovery Act should be amended to include Puerto Rico in the list of countries that the President shall consider as beneficiary countries.

That concludes my comments, Mr. Chairman.

[The prepared statement of Mr. Murphy appears in the appendix.]

The CHAIRMAN. Mr. Murphy, that counsel will be helpful to us. I think you made some valid points. We are pleased to have you. Thank you.

Mr. MURPHY. Thank you.

The CHAIRMAN. Our next witness will be Mr. Arnold Tompkins, who is the Acting Assistant Secretary for Planning and Evaluation, Department of Health and Human services.

Mr. Tompkins, we are pleased to have you. If you would, proceed.

Mr. TOMPKINS. Yes, sir.

STATEMENT OF ARNOLD R. TOMPKINS, ACTING ASSISTANT SECRETARY FOR PLANNING AND EVALUATION, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. TOMPKINS. I appreciate the opportunity to appear before the committee to provide information on the impact of S. 712 on the operation of HHS programs in Puerto Rico.

The Department provides approximately $2.6 billion per year to or on behalf of residents of Puerto Rico or the Government of Puerto Rico.

We believe it is important to provide an opportunity for the people of Puerto Rico to choose their future relationship with the United States and consider that the major provisions in the bill are, in general, workable. I will briefly summarize the principal effects of the bill on HHS programs:

First, independence. Our primary concern with the independence option is ensuring an equitable and manageable transition to Puerto Rican Social Security and Medicare systems. Currently, Puerto Rican employers and almost 600,000 employees are covered by Social Security, and 400,000 by Medicare, in the same manner as employers and employees in the 50 States.

S. 712 recognizes the complexity of, and equity concerns in, transition to Puerto Rican systems for both Social Security and Medicare, and establishes a commission to address this transition to the new systems. We support this approach.

In particular, as regards Social Security, we consider use of a totalization agreement, similar to those we have with 11 other countries, as an effective mechanism.

Under the statehood option, expenditure ceilings on several of our entitlement programs will be removed, and a federally-administered Supplemental Social Security Income program will be phased in. We expect that Puerto Rico would participate in the foster care program and expand AFDC and Medicaid programs.

We estimate additional Federal expenditures under those programs would be in excess of $1.5 billion by 1995; they would be significantly higher under CBO estimates.

Extension of SSI would constitute a major change for individuals affected by the communities of Puerto Rico, with potentially significant effects on the Puerto Rican economy and social institutions. S. 712 provides a mechanism that could be used for addressing the most appropriate manner of extending Federal programs, including SSI, through establishment of a Commission on Federal Laws. Consideration could be given to (1) ensuring that the Commission will address issues such as how to implement SSI; and (2) making the Commission recommendations available to Congress, Puerto Rico, and Federal agencies much earlier than they are now called for in the bill.

The statehood provisions in the bill would change the way in which hospitals are reimbursed under Medicare in Puerto Rico. Currently, Puerto Rico hospitals are reimbursed at a blended rate based 25 percent on the national rate and 75 percent on the local rate in Puerto Rico.

If Puerto Rican hospitals were to be paid on the same basis as hospitals in the States, payments would be about 36 percent higher than current payments. Because hospital costs are substantially lower in Puerto Rico, this could result in overpayments to Puerto Rican hospitals.

S. 712 addresses this by limiting reimbursements to Puerto Rico to "actual costs providing equivalent health care to levels of care provided in the several contiguous States." This, however, would be inconsistent with the prospective payment approach, which is designed to provide incentives to control costs.

Commonwealth status as provided for in S. 712 would have little direct effect on HHS programs. The most significant change is related to the bill's provision allowing Federal agencies to consolidate certain financial assistance programs. We do not anticipate that the consolidation provision—as currently drafted and as we apply it to other insular areas—would allow consolidation of entitlement programs.

Thank you for this opportunity, and I will be happy to answer any questions you may have and provided any additional information needed.

[The prepared statement of Mr. Tompkins appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Secretary.

Analysis by the General Accounting Office and the Congressional Research Service shows that, if Puerto Rico became a State, there would be a very substantial increase in the welfare program and welfare dependency in Puerto Rico, at a level substantially higher than that of any other State. Do that give the Administration any concern? Do you regard that as a problem? If so, what do you think ought to be done about it?

Mr. TOMPKINS. I think, in the instance I have mentioned, in particular that dealing with SSI, we have some concern about what it may do to the economy of Puerto Rico, particularly given the great difference between what people are now receiving under the Aid to the Aged, Blind, and Disabled program now in Puerto Rico and that which they will receive under SSI. We have only concerns about this. As the Department has been instructed by OMB, any budgetary effects that occur, the Administration is willing to accept.

The CHAIRMAN. What about an alternative approach? Under the legislation before us, statehood, as I understand it, would provide for the immediate welfare benefits; but the tax responsibilities are phased in. What if the phasing-in of the tax benefits was matched by a phasing-in of the welfare benefits, the increase of the welfare benefits? Would that be a viable option?

Mr. TOMPKINS. That could be a viable option, and that was discussed at the hearings with the Energy Committee and the Commerce Committee before on this issue.

The CHAIRMAN. Can you tell me what the Administration would prefer about those two options?

Mr. TOMPKINS. I am really not at liberty to say. I think that has been discussed, but it is not conclusive, to my knowledge.

The CHAIRMAN. Do you mean you can't tell me which one you prefer, one or the other?

Mr. TOMPKINS. No, I can't. As to discussions on my side, it was the expenditures side, and on Treasury's, the revenue side, and I have not been involved in any discussions as far as what would be acceptable or not acceptable.

The CHAIRMAN. I must say that is not very helpful.

Thank you very much, Mr. Tompkins.

Next we have a panel that consists of Mr. Michael McKee, who is a Principal in Quick, Finan and Associates; Mr. Jose Berrocal, who is Counselor to the Governor, and Mr. William Ocasio, Executive Director of the Governor's Economic Advisory Counsel; Dr. Francisco Catala, who is Special Advisor, Economics and Trade, for the Puerto Rican Independence Party, and Pedro Parilla, who is Secretary of Finance of the Puerto Rican Independence Party.

Mr. McKee, if you would proceed, please.

STATEMENT OF MICHAEL J. McKEE, PRINCIPAL, QUICK, FINAN & ASSOCIATES, WASHINGTON, DC

Mr. McKEE. Thank you, Mr. Chairman.

I am Michael McKee, a Principal and Managing Director of Quick, Finan and Associates, appearing again today on behalf of the statehood party of Puerto Rico. I thank the Senate Committee on Finance for consenting to hear our views on the economic and social welfare implications of admitting Puerto Rico into the Union of States.

Previously I served as a Senior Staff Economist for the President's Council of Economic Advisers and the U.S. Treasury's Office of tax Analysis, as well as at the Organization for Economic Cooperation and Development in Paris. For more than a decade I have specialized in analyzing structural adjustment issues—that is, how shifts in taxes, social programs, regulations, development policies, and other actions that change the underlying structure of the economy affect economic growth and performance.

I want to make five points today, about the relationship between welfare benefits and economic development in a State of Puerto Rico, and I note I have a full statement submitted for the record.

The CHAIRMAN. That will be accepted.

Mr. MCKEE. First, looking at aggregate taxes and outlays, from a budget perspective it is the net effect rather than outlays alone that matter. On this, estimates all show that statehood, when fully phased-in, will provide a net surplus compared to commonwealth.

The CHAIRMAN. A net surplus to who?

Mr. MCKEE. A net surplus in the out-years to the Federal Treasury; that is, after full phase-in.

The CHAIRMAN. All right.

Mr. MCKEE. Deficits occur during the transition period, but their magnitude and duration are not inherent in statehood as a status, but rather in the balancing of the need for an appropriately long and smooth transition, with the desire for Federal fiscal prudence.

Regarding welfare outlays, the first question, I believe, is the tilt question. Commonwealth advocates demean their own citizens by arguing that their votes can be bought by welfare; but it is the people whose jobs are felt to be in jeopardy who vote, not the poor.

Section 936 companies have repeatedly stated in their advocacy documents that the Island's residents have a strong work ethic; they have excellent skills and good work attitudes; they are productive by world-class standards; native management is excellent; and it is commonwealth advocates who want the employed to believe they will lose their jobs in the State of Puerto Rico. That is truly a tilt.

Some Senators feel the increase in Federal outlays for welfare benefits under statehood will build a welfare society; but this is not addressed by the budget numbers, which alone do not answer three relevant questions: Who benefits, and by how much? What happens, in total, to marginal benefit and tax rates? And what employment opportunities does the statehood economy provide?

First, on the programs, the EITC is an incentive to work.

Second, SSI, Medicare, and a significant portion of Medicaid, will go to those who cannot work, nor whom a decent society would want to be forced to work—the aged, blind, disabled, ill, and children.

Third, AFDC benefit increases to potentially able-bodied workers appear relatively small. Only the increase in food stamps appears sizable. But there is already a sizable program.

Some observers have said that, since many Island residents are on food stamps—some 40 percent are today—the work incentive is harmed. This may be true to a very small extent, but a historical review of the data show that the driving force in unemployment and labor force participation on the Island has been the rapid transition to industrialization and the shocks of the 1970s and 1980s. The last had a major impact on the economy's not yet diversified industrial base. Those who registered themselves as unemployed are people who want to work.

Finally, will the Island become a permanent welfare economy if the corporate welfare of section 936 is ultimately withdrawn? No. Any objective view of the Island's potential would show that the Island is attractive by mainland standards because of its ample and inexpensive skilled labor force. It would be a perfect place for foreign investment in manufacturing, but it is omitted from the tax-treaty web those investors require. It is strategically located vis-a-vis Latin America, but why be in a political half-way house when one needs to be in the United States?

Puerto Rico also has an increasingly educated population. Forty percent of those between ages 16 and 24 are in universities. The population is increasingly bicultural and bilingual—42 percent bilingual at last count. Many of these best and brightest now come to the Mainland after university. I have met many expatriates here in Washington.

Finally, it has a stable government, widely viewed as pro-business and skilled in working with business. It becomes more attractive under statehood, because of the greater certainty of the investment and business environment, and the entrepreneurial self-respect that statehood would bring.

In concluding, I submit that fears about the permanent welfare society are badly misplaced. Furthermore, permanent reliance on development based on section 936, itself a continuously-threatened program, is a recipe for ultimate economic disaster.

Thank you. Mr. Chairman.

[The prepared statement of Mr. McKee appears in the appendix.]

The CHAIRMAN. That was an interesting and in places a somewhat provocative statement.

Tell me, did you state that Puerto Rico is 42 percent bilingual?

Mr. McKEE. Those are the statistics I have gotten. I don't have a source with me, but I can find the source.

The CHAIRMAN. No, no, that is fine. Is that challenged by any other member of the panel?

Mr. BERROCAL. Mr. Chairman, the 1980 Census indicates that 58 percent of the people of Puerto Rico speak no English, approximately 23 percent with some difficulty, and 19 percent indicate that they speak English without difficulty.

Mr. McKEE. Let me add to that. Things continue to change dramatically in education in Puerto Rico, and that was the 1980 Census.

Mr. BERROCAL. That is right.

The CHAIRMAN. Mr. José Berrocal, would you proceed, sir?

STATEMENT OF JOSÉ BERROCAL, COUNSELOR TO THE GOVERNOR, COMMONWEALTH OF PUERTO RICO, SAN JUAN, PR, ACCOMPANIED BY DAVID GRACE, WASHINGTON, DC

Mr. BERROCAL. Good morning, Mr. Chairman.

I am José Berrocal, Counselor to the Governor of the Commonwealth of Puerto Rico. I am accompanied by Mr. David Grace. It is my pleasure to appear before you to discuss ways in which the Commonwealth of Puerto Rico, created in 1952 as a compact between the people of Puerto Rico and the Congress of the United States, can be enhanced to strengthen its economic development within the context of today's increasingly interdependent and interrelated world economy.

As a small and densely populated society with limited natural resources, Puerto Rico's prospects for economic growth are necessarily tied to the search for outside markets and trade. Our economic history during the last 40 years is one of dramatic growth and industrialization, fueled by an influx of capital and technology and an outflow of goods and services.

An industrious and determined people, in the span of two generations, we have gone from being the poorest of the poor in the hemisphere to enjoying today the highest standard of living in all of Latin America. Trade has been the key to our development.

Puerto Rico's exports have boomed over the past four decades, as has our GNP. Close to 80 percent of our trade has been with the United States, thanks to our common market; yet, in our quest for added self-sufficiency, we need to diversify our markets and sources of capital. Our economic development has been staggering; but, with a per capita income approximately one-third that of the United States, Puerto Rico has a long way to go.

The Commonwealth Title of S. 712 contains three provisions designed to enhance Puerto Rico's economic development and accelerate the Commonwealth's participation in the world economy.

First, under the Generalized System of Preferences, industrialized nations provide unilateral, non-reciprocal preferential treatment to imports from developing countries, territories, and political entities. The GSP treatment and other regional systems of preferences are designed to accelerate the economic development of these entities by encouraging greater diversification through additional export opportunities.

GSP programs provide valuable benefits, benefits which could potentially be extremely helpful in the development of the Puerto Rican economy, particularly in light of our efforts to promote the economic integration of the Caribbean Basin region.

Even though the per-capita GNP of Puerto Rico is similar to that of other developing societies that have been accorded GSP treatment, the Commonwealth does not presently receive this preferential treatment. The proposed legislation would require the United States' Executive Branch to assist Puerto Rico in seeking favorable treatment from foreign countries for exports from the Commonwealth, and to encourage other countries to consider Puerto Rico as a developing territory for purposes of their respective GSP programs.

I should note that a similar provision has been enacted into law by Congress for the benefit of the Commonwealth of the Northern Marianas, and GSP treatment has already been obtained for the U.S. Virgin Islands, Guam, American Samoa, and the Pacific Trust Territories. While it may appear a relatively modest request, to ask the U.S. Government to encourage other countries to consider Puerto Rico as a developing area for purposes of their respective GSP programs, it has not been possible to obtain such assistance from the U. S. Government in the absence of an affirmative congressional policy statement to this end.

I can go into greater detail about our history of difficulty in that area, but I would like to continue, for purposes of time.

The CHAIRMAN. Well, that is an interesting statement.

Mr. BERROCAL. Our second item is the special tariff-setting authority. As the USTR indicated, since 1930 Puerto Rico has enjoyed tariff-setting authority with respect to foreign coffee. This was enacted to save our coffee industry in the 1920s and 1930s. This provision has allowed Puerto Rico to develop coffee production nearly sufficient to meet local demands, and permits us to employ over 30,000 farm workers in the center of our island, very needy people.

The proposed legislation would extend this existing authority to cover those other products of special interest to the Commonwealth, where doing so would be consistent with U.S. international obligations.

I will submit the remaining statement for the record, Mr. Chairman. Thank you very much.

The CHAIRMAN. That will be fine. Thank you very much. You made some interesting discussions there. You also have added to my education. Thank you.

[The prepared statement of Mr. Berrocal appears in the appendix.]

The CHAIRMAN. Dr. Catala, we are pleased to have you. If you would, proceed.

STATEMENT OF FRANCISCO CATALA, PH.D., SPECIAL ADVISOR, ECONOMICS AND TRADE, PUERTO RICAN INDEPENDENCE PARTY, ACCOMPANIED BY PEDRO PARILLA, PH.D., SECRETARY OF FINANCE, SAN JUAN, PR

Dr. CATALA. Mr. Chairman, my name is Francisco Catala, and I am with Professor Pedro Parilla. We are honored to testify before this committee on behalf of the Puerto Rican Independence Party.

Since there is a limitation on time, we have already submitted a written statement on the position of the Puerto Rican Independence Party on trade issues, Social Security, and Federal grants. In fact, we agree with S. 712 and with the report of the Committee on Energy and Natural Resources; except that, in light of the obvious administrative considerations which mandate a concern for smoothness in phasing out Puerto Rico's dependency, we regard the complete transition we had originally proposed as preferable.

We call upon this committee to face the fact that, even with the complete transition we request, independence remains by far the most convenient option from the point of view of the U.S. Treasury. That transition is detailed in our written statement and in our original proposal.

I will read a short statement now on the trade issue:

Puerto Rico is one of the most open economies in the world, with a combined volume of imports and exports nearly twice the size of the gross product. By far, the majority of this trade has been with the United States, which provides the bulk of Puerto Rico's imports and the main market for its exports.

In the last three fiscal years the United States has accounted for about 88 percent of Puerto Rico's total exports, or total merchandise exports. On the other hand, Puerto Rico has become a major market for the United States In fiscal year 1988, the Island's merchandise purchases from the United States amounted to almost $8 billion, a figure equivalent to 43 percent of local gross product in that year. This level of imports exceeded that of at least 10 other major trading partners of the United States. Such countries as France, Italy, Brazil, Venezuela, China, Hong Kong, and Singapore were surpassed by Puerto Rico in terms of imports form the United States

Similarly, Puerto Rico's imports from the United States were only $1.4 billion less than the combined total of Australia, New Zealand, and South Africa.

Considering that Puerto Rico's population is about 3.3 million, it is considerably smaller than that of most of the U.S. major trading partners, the Island is probably the biggest U.S. customer in percapita terms.

Direct access of Puerto Rico's product to the U.S. market has been indicative of the economic relationship between the two countries and the cornerstone of the Island's industrialization historically. Nevertheless, it should be noted that the special advantage provided by free access to the United States has been eroded in the last two decades as the U.S. Government has granted freer access to its market to other countries as part of GATT negotiations, and more recently under the CBS initiative.

It is in the best interests of both the United States and Puerto Rico that good trade relations be maintained after the Proclamation of Independence. A special trade regime between the Republic of Puerto Rico and the United States will not only strengthen the bonds of friendship and mutual respect, but will also facilitate continued economic development of Puerto Rico and enable us to play a positive role in the development of other Caribbean and Latin American nations.

With respect to the latter, it should be pointed out that the Caribbean and South America are the two most important trading regions from Puerto Rico's viewpoint after the United States.

The current draft of S. 712 allows Puerto Rico to opt for beneficiary status under the Caribbean Basin Initiative, or to enter into a mutual free-trade agreement with the United States. It also offers most-favored-nation treatment for Puerto Rico after it becomes independent. These provisions, although capable of providing the direct-access guarantees which were earlier proposed or suggested should be further clarified to expressly indicate our intent to safeguard the maximum access of Puerto Rican product to the U.S. market, as proposed in the Report of the Committee on Energy and Natural Resources.

This desirable free-trade arrangement between the United States and the Republic of Puerto Rico would not necessarily mandate open trade of all goods between the two nations; but, to the extent that there are limitations, those limitations would be as mutually agreed and would, overall, provide mutual benefits to both nations and would assist each in meeting its trade and economic development objectives.

Thank you.

[The prepared statement of Dr. Catala appears in the appendix.]

The CHAIRMAN. Thank you very much.

Gentlemen, we have limitations on time. I apologize for other members not being here, but we are having a joint session of the Congress with Lech Walensa, and that is where the rest of them are.

I must tell you, though, that the testimony you have developed for us is going to be very helpful for this committee in arriving at a judgment. We anticipate having additional hearings next year concerning these specific issues. But the points that you have individually raised are obviously going to bring to mind other questions as we probe and try to decide what we should do within the jurisdiction of this committee. We are going to be much better informed because of the contributions that you have made.

Thank you very much for your appearance today.

Our next panel consists of Ms. Linda Morra, Director of Intergovernmental and Management Issues, Human Resources Division, U.S. General Accounting Office; Ms. Carolyn Merck, Specialist in Social Legislation, Congressional Research Service, Library of Congress; and Mr. Charles Seagrave, Chief of Human Resources Cost Estimates, Budget Analysis Division of the Congressional Budget Office.

Ms. Morra, would you proceed with your statement, please?

STATEMENT OF LINDA G. MORRA, DIRECTOR, INTERGOVERNMENTAL AND MANAGEMENT ISSUES, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. Morra. Thank you.

I am pleased to be here today to provide background information on Puerto Rico for the committee. I will begin with an overview of Federal spending and Federal tax policies.

Federal spending comprises about 30 percent of Puerto Rico's gross product. In the 50 States, the average is about 22 percent. Puerto Rico's gross product was about $18 billion in 1988, with Federal spending about $6.2 billion of that. In addition to Federal spending, certain tax benefits accrued to both individuals and corporations. Islanders and U.S. corporations doing business in Puerto Rico are for the most part exempt from Federal taxes. In a 1987 report, we estimated that in 1983 the Federal Treasury would have received an estimated $2.4 billion if Federal tax laws were extended to Puerto Rico. Finally, the Federal Government provided $703 million to Puerto Rico in direct loans, loan guarantees, and insurance in Fiscal Year 1988.

Generally, Puerto Rico is treated as a State under most Federal laws and programs. The major exceptions are in the tax laws, income-support programs, and health care programs. Since CRS is going to discuss, income-support programs and health care programs, I am going to concentrate on tax laws.

Puerto Rico is not subject to Federal individual or corporate income tax laws. Two provisions in Federal tax law are designed to encourage industry and improve the Puerto Rican economy.

The first is the Possessions' Tax Credit, also known as section 936 of the Internal Revenue Code. It, in effect, exempts the income U.S. firms earn from business operations and certain financial investments in Puerto Rico from Federal corporate income taxes. According to the Department of the Treasury, in 1983, 625 corporations in Puerto Rico received benefits equalling $1.6 billion. These companies employed about 89,000 employees. The estimated tax benefit per employee averaged $18,523, or 125 percent of the average compensation per employee.

The second provision, section 7652(a) of the Tax Code, allows taxes on items produced in Puerto Rico and sold in the States or consumed on the Island to be deposited in the Treasury of Puerto Rico. Puerto Rico received $227 million under this provision in 1987.

While similar to the States' governmental structures in most respects, Puerto Rico's system of government has two unique characteristics:

First, the central government directly provides services such as public education, health, police and fire services that in the 50 States local governments generally provide. The government is the Island's largest employer. Municipalities are the only political subdivisions in Puerto Rico, and they have limited service-delivery responsibilities.

Second, Puerto Rico relies on 52 public corporations to deliver many kinds of services. While some, such as the University of Puerto Rico and the Electric Power Authority, have counterparts in the States, others do not. For example, Puerto Rico's Telephone Authority and Communications Authority operate the Island's telephone system; and the Sugar Corporation grows sugar cane, buys it from private firms, processes it, and markets it. In 1987, 11 of the largest of these corporations had net assets of about $5 billion and revenues of about $2.7 billion.

It is not clear how a status change might affect either characteristic.

The aggregate short-term financial condition of the Commonwealth's central government, its public corporations, and its municipalities shows a surplus. The Commonwealth's 1990 budget projects revenues of about $10.5 billion for 1989 and expenditures of about $9.8 billion.

Puerto Rico, however, has a relatively high public debt. Excluding the debt attributable to public corporations, the percent of the Commonwealth's and municipalities' debt in relation to the Island's gross product is about one-third higher than the average for the 50 States and their localities.

Total revenues for Puerto Rico's central and municipal governments, excluding the public corporations, will be about $4.8 billion in 1989. This is about 26 percent of the Island's gross product. For the 50 States, the average is about 18 percent.

The largest share of total revenues, 24 percent, will be from Federal aid. This is nearly twice the average for the 50 States. The other components, almost equally divided, are sales, and individual and corporate income taxes.

The implications of the status option for independence on revenues are not clear. Even though nearly a quarter of the government's revenues are derived from Federal assistance, it is unclear whether it would necessarily lose this support under the independence option. For example, treaties similar to those in the Philippines on base-use payments could supplement an independent Puerto Rico's budget.

Under the statehood option, the heavy reliance on income taxes, especially corporate income taxes, would probably change because of the imposition of Federal income taxes. This could place pressures for increasing other tax sources. The option of continued commonwealth would probably have very little effect on revenues.

Excluding the public corporations, the Commonwealth spends about 29 percent less per capita than State and local governments. The independence status option would create new demands for expenditures, potentially in defense, postal, and other services.

The statehood option could result in pressure for the Commonwealth to increase its expenditures in the areas of income security and health care, as Federal matching programs drive greater expenditures.

Under the commonwealth status option, the potential for change is unclear.

Mr. Chairman, this concludes my presentation, and I will be happy to answer any questions you may have.

[The prepared statement of Ms. Morra appears in the appendix.]

The CHAIRMAN. Thank you.

Ms. Merck, if you would, please proceed.

STATEMENT OF CAROLYN L. MERCK, SPECIALIST IN SOCIAL LEGISLATION, CONGRESSIONAL RESEARCH SERVICE, LIBRARY OF CONGRESS

Ms. MERCK. Thank you, Mr. Chairman.

My name is Carolyn Merck. I am a legislative analyst with the Congressional Research Service. The purpose of my testimony today is to describe how welfare programs and recipients might be affected by a change in Puerto Rico's status. My statement is largely drawn from a report CRS prepared last summer, at Senator Moynihan's request.

I would like to preface my testimony by saying that I will not address program costs or budget effects, as the Congressional Budget Office is charged with the responsibility of providing such estimates to the Congress.

In order to keep my statement brief, I will discuss only the most significant changes that would occur if statehood were to be chosen in the referendum. Most welfare programs would be unaffected by the enhanced commonwealth option; and, under independence, welfare programs would no longer be the responsibility of the U.S. Government.

If statehood were to be the outcome of the referendum, the Earned Income Tax Credit and the Supplemental Security Income and Food Stamp programs would undergo the most significant changes in scope. These programs are federally financed, have nationally uniform eligibility and benefit criteria, and are generally geared to serve a population whose income is low relative to mainland U.S. incomes. Because incomes in Puerto Rico are far below those of even the poorest State, the eligibility levels for these programs would occur at a point below which a large segment of the Island's population would fall.

The Earned Income Tax Credit is a refundable credit for households with earned income and dependent children. It is not available in Puerto Rico, because it is part of the U.S. income tax system. However, upon implementation of the Federal income tax in the State of Puerto Rico, this program would be extended to all working Puerto Rican parents with adjusted gross incomes below $19,340, and that is in 1989.

Given the distribution of family income in Puerto Rico, a rough estimate shows that in 1979 almost two-thirds of all Puerto Rican families with children would have been eligible for the EITC if it had been available then at today's real dollar levels.

The Supplemental Security Income program, which is not available in Puerto Rico, provides federally financed, nationally uniform monthly cash assistance to low-income elderly, blind, and disabled persons.

Instead of SSI, the Commonwealth operates a program of Aid to the Aged, Blind, and Disabled according to locally-determined eligibility and benefit criteria. Federal funds going to Puerto Rico for AABD are subject to an annual cap, and the Commonwealth is required to pay 25 percent of benefit costs.

Under statehood, SSI would replace the AABD program at 100 percent Federal expense, and the cap on Federal funds would be removed. For a single individual, the income eligibility and maximum benefit levels would increase from $32 monthly to $368, or to about $245 if the recipient lived in another's household. A jump of this magnitude undoubtedly would expand the population eligible, increase payments to program participants 8- to 11-fold, and could potentially affect persons other than SSI recipients. The elderly in Puerto Rico tend to live in extended households, and a large increase in the income of one household member might create a work disincentive for other household members.

Although the Food Stamp program is not under the jurisdiction of this committee, its counterpart, the Nutrition Assistance Program, is the linchpin of Puerto Rico's welfare system. The NAP provides more money and affects more people in the Commonwealth than all other means-tested welfare programs put together.

Statehood would require the extension of the regular Food Stamp program to Puerto Rico, with four major consequences:

Benefits would have to be issued in food stamp coupons rather than cash, requiring implementation of redemption procedures and monitoring of food store operations;

The number of recipients would increase by about 400,000 persons, to well over half of the population;

Benefits to participants would rise significantly, by at least 20 percent, and probably more;

Puerto Rico would lose the very substantial flexibility it now has to design its major cash welfare program as it sees fit, without the panoply of Federal food stamp rules that States must follow.

Overall, this increase in income to a large segment of the Island's population in the form of coupons earmarked for food could create distortions of uncertain dimensions in food markets and the economy in general.

Puerto Rico decides benefit levels and eligibility criteria for the Aid to Families with Dependent Children program, as do the

States. However, unlike the program in the States, funding is subject to a cap, and Puerto Rico is required to pay 25 percent of benefits costs.

The CHAIRMAN. Twenty-five percent of what?

Ms. MERCK. Benefit costs.

AFDC covers only about 5 percent of the population, and thus is much smaller in scope than the NAP or, potentially, the Food Stamp program.

If Puerto Rico were to become a State, the cap on Federal funding would be removed, and the Federal Government's share of benefit costs would rise from 75 percent to 83 percent. However, it is unclear how Puerto Rico would respond to open-ended funding for AFDC at an 83 percent matching rate. By spending somewhat less money, Puerto Rico could maintain existing benefit levels. Because the Food Stamp program would be available to a broader population and would offer higher benefits at no cost to Puerto Rico, there would appear to be little reason for Puerto Rico to expand its AFDC program.

The Medicaid program is available in Puerto Rico under current law, but it functions under vastly different rules from those that prevail in the States. Medicaid funding in Puerto Rico is capped, and the Commonwealth must pay half of program costs. Under statehood, the cap on Federal funds for Medicaid would be removed, and the Federal share of costs would rise from 50 percent to 83 percent. As a result, Federal spending for Medicaid in Puerto Rico could more than double.

The CHAIRMAN. Well, it varies in the various States.

Ms. MERCK. Yes, it does, inversely with per capita income.

The CHAIRMAN. But you were saying Puerto Rico would go to the maximum?

Ms. MERCK. That is right.

In addition, Puerto Rico would become subject to new requirements for furnishing more extensive coverage to some classes of individuals, while cutting off coverage to others. Also, Puerto Rico would no longer be permitted to restrict Medicaid providers to public hospitals and clinics, as it does now.

In conclusion, under the statehood option for Puerto Rico, a sharp rise in welfare benefits could dramatically reconfigure the outline of the Island's income distribution. While, on the one hand, this could have salutary effects on the living standards of many low-income people, the effect on labor force participation and work disincentives in an economy in which labor force participation is already low and unemployment is very high is an issue of serious concern.

This concludes my testimony. I would be glad to take questions.

[The prepared statement of Ms. Merck appears in the appendix.]

The CHAIRMAN. I am curious as to why, as a public policy matter, they restrict Medicaid to public hospitals. Why?

Ms. MERCK. Puerto Rico's program has a waiver from the "freedom of choice" of health care providers that applies in the 50 States. And, historically, public health care facilities provided Medicaid service, which, in Puerto Rico, remains the local practice. That is where the low-income population tends to get their medical care, and therefore it is the system that is now in operation.

The CHAIRMAN. I see.

Mr. Seagrave, if you would, proceed, please.

STATEMENT OF CHARLES E. SEAGRAVE, CHIEF, HUMAN RESOURCES COST ESTIMATES UNIT, BUDGET ANALYSIS DIVISION, CONGRESSIONAL BUDGET OFFICE

Mr. SEAGRAVE. Thank you, Mr. Chairman. It is a pleasure to appear before the committee to discuss the Congressional Budget Offices's cost estimate of S. 712, the Puerto Rico Status Referendum Act.

CBO's current estimate of the bill is as the bill was ordered reported by the Committee on Energy and Natural Resources on September 6, 1989. Only spending estimates arc discussed in the estimate. As you know, revenue estimates are being undertaken by the Joint Committee on Taxation.

CBO has have prepared some background materials on the costs of the Puerto Rico Status Referendum Act. Those materials contain three summary tables and the complete cost estimate that CBO has prepared.

As Table 1 shows, based on actual data from the Bureau of the Census, in 1988 the Federal Government spent $6.2 billion in Puerto Rico. The composition of that spending is displayed in Table 1.

CBO has examined the growth in that spending in recent years and found that it had been increasing about 6 percent a year. We used that 6-percent growth rate in conjunction with the 1988 data to project spending over the 1992-1995 period. This appears as line 1 in Table 2. Consequently, we anticipate, in 1992, that $7.9 billion will be spent by the Federal Government in Puerto Rico, rising to $9.4 billion in 1995.

We have also examined the incremental effects of the three status options contained in S. 712 under these baseline assumptions. The enhanced commonwealth option would have insignificant effects on total spending in Puerto Rico. The nature of the spending could change. The bill would allow consolidation of many grants that are currently provided to Puerto Rico. Overall, however, we think total spending would change little under the enhanced commonwealth option.

Under the independence option, we find that in 1994 and 1995 there would be minor reductions in Federal spending. The bill would have the Federal Government look at the amount of money it was spending in the year before the Proclamation of Independence, and would have the Federal Government continue those payments over a 9-year period. Since spending to Puerto Rico currently rises each year, continuing those payments at a constant level would result in the savings shown, or about a tenth of a billion dollars in 1994, and $.3 billion in 1995.

The statehood option would result in significant increases in Federal spending. Under our estimates, the increases would rise from $1.7 billion to $3.3 billion in 1995.

Since I am sitting at the table with GAO and CRS, I would like to thank both of them. They helped greatly in preparing these estimates. And while we certainly cannot hold them responsible for any problems, CBO has appreciated the cooperative effort of the congressional agencies on this issue.

The CHAIRMAN. I am not through with you. I have some more things I am going to ask the three of you.

But, go ahead.

Mr. SEAGRAVE. Table 3 examines the increases in some of these entitlement programs, which Carolyn Merck has outlined earlier. The largest increase in our estimates is in the Medicaid program, where we feel that Federal Medicaid costs would grow from $.9 billion in 1992 to $1.2 billion in 1995.

The CHAIRMAN. Is that particularly because of the shift in the sharing option from 50-50, as I now understand it to be, to something like 83-17?

Mr. SEAGRAVE. It is because of both the shift from 50-50 to 83-17 and the removal of the cap, which currently exists. In 1990, Federal spending is limited to $79 million.

Other major increases would be in the Food Stamp program, replacing the current Nutrition Assistance Block grant, where we feel spending will rise by about $700 million a year, and in SSI, which in 1995 we estimate would add $900 million to Federal spending.

In conclusion, I would like to make clear that these estimates are somewhat uncertain. We do not have the detailed data bases on Puerto Rico that we do for the continental 48 States. The estimates also depend critically, or at least importantly, on reactions of the Puerto Rican economy.

Thank you very much.

[The prepared statement of Mr. Seagrave appears in the appendix.]

The CHAIRMAN. All right. And yours, of course, is on the spending side.

The argument has been made here, amongst the witnesses, that statehood would bring about a substantially larger cost than has so far been estimated, because of the economic impact of eliminating the Internal Revenue Code, section 936. You have heard that argument. I would like you to comment on whether that impact has been considered in developing your costs.

Mr. SEAGRAVE. No impact of section 936 has been included in these estimates for a couple of reasons:

The estimates run through 1995, and, as the bill was ordered reported by the Energy and Natural Resources Committee, the 936 provisions phase out over time. They would be 20 percent phased out in 1994, and 40 percent phased out in calendar year 1995. We don't think, in those 2 years, 936 will have a major impact.

The CHAIRMAN. But then let me say that I would like for the Congressional Budget Office, in consultation with the General Accounting Office and the staff of the Joint Tax Committee and CRS, to undertake an economic analysis of the likely impact of the proposed tax code changes under the statehood option, a coordinated study of that. And then, of course, we have not reviewed or reached any decision on the exact pattern of how it will phase in the tax and benefit changes under the options. That adds to your problem.

But simply as a working hypothesis, I would like for the CBO to assume a gradual phase-in of both the benefit and the tax provisions over a 5-year period or a 10-year period. And you ought to assume that that is done in a manner that attempts to maintain budget neutrality throughout the period.

Now, when you do that analysis and the study, you ought to also get whatever evidence the three parties want to submit, as they try to influence that analysis toward their point of view.

Mr. SEAGRAVE. We will be glad to try, Mr. Chairman.

The CHAIRMAN. But let them have a shot at it. Let them present their versions, and then try to give us an objective analysis of that.

You have given us a wealth of information, and I must state that it is a highly complex subject. It is obvious we are going to have to get a great deal more study, from the point of view of this committee, in those areas in which it has jurisdiction.

I appreciate very much the testimony that has been presented to us. It is obvious we are going to follow up with some written requests and want some additional information, and we will be having additional hearings next year.

Thank you very much for your attendance.

[Whereupon, at 11:25 a.m., the hearing was concluded.]

APPENDIX

Alphabetical Listing and Material Submitted

SUBMITTED BY SENATOR LLOYD BENTSEN

[JOINT COMMITTEE PRINT]

TAX RULES RELATING TO PUERTO RICO UNDER PRESENT LAW AND UNDER STATEHOOD, INDEPENDENCE, AND ENHANCED COMMONWEALTH STATUS (S. 712, PUERTO RICO STATUS REFERENDUM ACT)

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of tax rules relating to Puerto Rico under present law and under statehood, independence, and enhanced commonwealth status. S. 712, the Puerto Rico Status Referendum Act, was reported by the Senate Committee on Energy and Natural Resources on September 6, 1989, and has been jointly referred to the Senate Committee on Finance for consideration of matters within its jurisdiction.[2]

Part I of the document provides an overview of United States and Puerto Rican tax rules under present law. Part II provides a description of the provisions of S. 712 as reported by the Senate Committee on Energy and Natural Resources. Part III discusses tax implications of statehood, independence, and enhanced commonwealth status options for Puerto Rico under the bill. Appendix A lists selected Federal excise tax rates, and Appendix B lists selected Puerto Rican excise tax rates.

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[1] This pamphlet may be cited as follows: *Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act)* (JCS-19-89), November 14, 1989.

[2] S. Rep. No. 101-120, 101st Cong., 1st Session (1989). S. 712 also has been jointly referred to the Senate Committee on Agriculture, Nutrition, and Forestry.

I. PRESENT LAW

A. Overview of United States Tax Rules

1. Taxation of individuals

General rules

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. The rate structure currently consists of two brackets with rates of 15 and 28 percent.[3] Individuals are eligible for personal exemptions for themselves and for each of their qualified dependents of $2,000 in 1989. In addition, a standard deduction of $3,100 is permitted for single filers and $5,200 for joint filers in 1989. Thus, in general, no Federal income tax is due from a single filer with less than $5,100 of adjusted gross income.[4] The corresponding amount for a married couple with two dependent children would be $13,200.

As a general rule, every U.S. citizen or resident is required to file an annual U.S. individual income tax return. However, an individual whose gross income for a taxable year is less than the sum of the personal exemption amount and the basic standard deduction which is applicable to such individual is excused from this filing requirement.

The U.S. tax system permits numerous deductions, exclusions, and credits in the calculation of taxable income and tax liability. Certain expenses are permitted as itemized deductions that reduce taxable income if the sum of these expenses exceeds the standard deduction. In particular, State and local income and property taxes generally are permitted as itemized deductions.

The earned income tax credit is available to taxpayers who maintain a household for a child. In 1989, the credit equals 14 percent of the first $6,500 of earnings. The credit is reduced by 10 percent of income in excess of $10,240 and is completely phased out at $19,360. The earned income credit is refundable and thus the amount of credit that exceeds the tax otherwise due is paid to the taxpayer. For example, in 1989 a married couple with two children would owe no U.S. income tax and in addition would receive a payment from the U.S. Treasury if their only income were earned income of less than $15,600.

Nonresident alien individuals are subject to U.S. tax, at the above rates, on their net income effectively connected with the conduct of a trade or business in the United States. Such individuals are also subject to a tax (at different rates computed on the basis of gross income) on certain other types of U.S. source income. Puerto Rico generally is not included as part of the United States for this purpose or other purposes of the Internal Revenue Code.[5]

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[3] The phaseout of the benefits of the 15-percent bracket and personal exemptions results in a marginal rate of 33 percent for certain income levels.

[4] Other than for certain minor children who are claimed as dependents on their parents' return.

Treatment of foreign source income

In general, U.S. persons (e.g., U.S. residents and U.S. citizens no matter where they reside) are taxed on all their income whether from U.S. or foreign sources. A credit, with limitations, may be claimed for foreign taxes paid or accrued, or alternatively foreign taxes may be treated as an itemized deduction. For this purpose Puerto Rico is generally treated as a foreign country.

Code section 911 provides that a U.S. citizen or resident with a tax home abroad may under certain circumstances elect to exclude an amount of his or her foreign earned income from gross income. The maximum exclusion is generally limited to $70,000 per year plus certain housing costs No deductions, exclusions, or credits are allowed for amounts allocable to this excluded income.

Taxation of U.S. persons residing in Puerto Rico

Under the Jones Act,[6] Puerto Rico is deemed to be a part of the United States for purposes of acquiring citizenship of the United States by place of birth.[7] Thus, a person born in Puerto Rico is typically a U.S. person for U.S. tax purposes. However, section 933 of the Code provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Such income will generally be subject to taxation by the Commonwealth of Puerto Rico. Items of income earned from sources outside of Puerto Rico by U.S. persons who reside in Puerto Rico are generally subject to U.S. taxation.

Because Puerto Rico source income earned by U.S. citizens who reside in Puerto Rico is excluded from gross income for U.S. tax purposes, such individuals who earn less than the applicable threshold amount of income from non-Puerto Rico sources generally are not required to file a U.S. income tax return. Presumably, most income of residents of Puerto Rico is derived from sources within Puerto Rico. Thus, it is likely that the majority of Puerto Rican residents do not earn a sufficient amount of non-Puerto Rico source income to require them to file U.S. income tax returns.

Estate and gift tax

For U.S. citizens and residents, the amount subject to estate and gift tax is determined by reference to all property, wherever situated. For nonresident aliens, such amount is determined only by reference to property situated in the United States.

The Federal estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The gift and estate tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 55 percent on taxable transfers over $3 million (50 percent on taxable transfers over $2.5 million in the case of decedents dying and gifts made after 1992). The estate and gift tax rate for transfers in excess of $10 million is increased by five percent until the benefit of the unified credit and graduated brackets is recaptured.

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[5] Puerto Rico is generally treated as a "State" and as part of the United States, however, for purposes of the Federal Insurance Contributions and Unemployment Acts (Code secs. 3121(e) and 3306(j)). Thus, under present law, residents of Puerto Rico generally are subject to the Federal employent taxes imposed under these Acts.

[6] Ch. 145, 39 Stat. 951 (1917), 48 U.S.C. secs. 731 et seq. (1982).

[7] 48 U.S.C. sec. 733 (1982).

U.S. citizens and residents are allowed a unified credit of $192,800 in determining estate and gift tax. This is equivalent to an exemption for otherwise taxable transfers totaling $600,000. In place of the unified credit, nonresident aliens are allowed a credit of $13,000 in determining estate tax.

Under a special rule, a U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes only if citizenship was acquired solely by reason of citizenship of, or birth or residence within, the possession (secs. 2209 and 2501(c); *cf.* secs. 2208 and 2501(b)). Transfers of property by residents of Puerto Rico that are exempt from Federal estate and gift taxation in the United States under these provisions are generally subject to estate and gift taxation in Puerto Rico, the limited extent of which is discussed below in Part I.B.1. Estates of decedents qualifying under this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value of that part of the decedent's gross estate which at the time of death was situated in the United States bears to the value of the entire gross estate wherever situated (sec. 2102(c)(2)).

2. Taxation of corporations

U.S. corporations, in general, are subject to U.S. income tax on their worldwide income. Corporations are taxed at a 34-percent rate on income in excess of $75,000. The benefit of lower marginal tax rates on income less than $75,000 is phased out above $100,000 of income.

Foreign taxes paid or accrued are creditable, with limitations, against U.S. tax liability, or alternatively may be deducted in calculating taxable income. Special rules, described in detail below in Part I.C., apply to income derived in U.S. possessions by certain domestic corporations.

3. U.S. taxation of Puerto Rico obligations

The interest on a bond issued by the Commonwealth of Puerto Rico or its municipalities is generally exempt from tax (sec. 103). The exemption does not apply to any bond that is a non-qualified private activity bond (within the meaning of sec. 141), an arbitrage bond (within the meaning of sec. 148), or a bond issued in unregistered form.

B. Overview of Tax Rules of Puerto Rico

The Constitution of the Commonwealth of Puerto Rico provides that the power of the Commonwealth to impose and collect taxes and to authorize their imposition and collection by municipalities shall be exercised as determined by the Legislative Assembly and shall never be surrendered or suspended. Under its Income Tax

Act, Excise Tax Act, and Estate and Gift Tax Act, Puerto Rico has imposed such taxes in ways that are in some ways similar to, and in other ways different from, U.S. Federal taxes. In particular, the Puerto Rico Income Tax Act was extensively reformed in 1987, in some instances closely following the Federal income tax changes of the Tax Reform Act of 1986.[8]

1. Taxation of individuals

Income tax

Individuals who are resident in Puerto Rico (regardless of citizenship) are subject to tax by the Commonwealth of Puerto Rico on their worldwide income. Generally, a person is considered a resident of Puerto Rico for Puerto Rican income tax purposes if that person is actually present in Puerto Rico and is more than a mere transient or sojourner. Resident individuals are entitled to deduct from gross income[9] those expenses which are connected with the conduct of a trade or business or with the production of income. Additionally, they can claim either certain itemized deductions or a standard deduction, whichever is greater. Itemized deductions include certain mortgage interest, residential property tax, auto license fees, certain casualty losses, and subject to limitations, medical expenses, charitable contributions, personal interest,[10] rent paid on the taxpayer's principal residence, and certain education costs. For 1989, the standard deduction is $3,000 for married persons filing joint returns, $2,000 for single individuals, $2,600 for heads of households, and $1,500 for married persons who file separate returns. Resident individuals are also permitted to claim personal exemptions in the amount of $1,300 for single persons, or $3,000 for married persons filing jointly or heads of households. Additionally, a personal exemption is allowed in the amount of $1,300 for each dependent of the taxpayer ($1,600 in the case of certain dependents who are full time university students). A married couple with two dependent children, for example, has no income tax liability if their income is less than $8,600.

Pursuant to the 1987 tax reform, marginal individual tax rates are reduced from a pre-reform high of 50 percent to 33 percent. This reduction is phased in over a three-year period commencing in 1988.[11] Similar to the U.S. tax system, the Puerto Rican tax system phases out the benefits of the graduated tax rates and personal and dependent exemptions at a 5-percent rate beginning at $75,000 of taxable income.

At the election of the taxpayer, interest income in excess of $2,000 earned by Puerto Rican resident individuals from deposits with Puerto Rican financial institutions may be taxed at a flat rate of 17 percent withheld at source. The first $2,000 of such income is excluded from taxable income. Additionally, a maximum tax rate of 20 percent applies to Puerto Rico source dividends, which tax is also withheld at source.

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[8] Although the Puerto Rican tax reform changes generally became effective soon after enactment, individuals may elect to delay the effective date of such changes for five years.

[9] Generally, gross income includes all income derived from whatever source, less certain exclusions. Items of exclusion include among others, gifts, inheritances, amounts received under a life insurance contract, interest on government obligations, and interest on individuals' savings accounts up to $2,000 annually.

[10] Similar to U.S. tax law, the deduction for personal interest is currently being phased out and will no longer be deductible following 1989.

[11] The top marginal rate for 1988 is 45 percent, for 1989 is 38 percent, and for 1990 and beyond is 33 percent.

Individuals with taxable income in excess of $75,000 are subject to an alternative basic tax, if the amount of such tax is higher than the taxpayer's regular tax. The rate of the tax varies from 10 to 20 percent as taxable income increases.

Nonresident individuals are taxed the same as residents with respect to income which is effectively connected with a trade or business conducted in Puerto Rico. Generally, nonresidents are subject to a withholding tax of 29 percent on non-effectively connected fixed and determinable annual or periodical income and capital gains.[12]

Estate and gift tax

For residents of Puerto Rico, the amount subject to estate and gift tax is determined nominally by reference to all property, wherever situated. However, property located in Puerto Rico is generally deductible from any gift and from the gross estate (except in the case of a U.S. citizen decedent whose worldwide gross estate is subject to U.S. estate taxation, as discussed below). Nonresidents of Puerto Rico are subject to estate and gift tax only on property located in Puerto Rico.

Puerto Rico's estate and gift taxes are unified, so that a single progressive rate schedule is applied to an individual's cumulative gifts and bequests. The estate and gift tax rates begin at 18 percent on the first $10,000 of taxable transfers and reach 50 percent on taxable transfers over $2.5 million. Nonresidents whose estates are subject to tax in their countries of origin are taxed in the amount of the maximum tax credit allowed by the estate tax rules of such country on property located in Puerto Rico, rather than by application of the progressive rates to property located in Puerto Rico. In the case of U.S. citizen decedents (1) who were resident in Puerto Rico and whose worldwide gross estate is subject to U.S. estate taxation, or (2) who were not resident in Puerto Rico and whose gross estate located in Puerto Rico is subject to U.S. estate taxation, the estate tax law provides that a tax equal to the maximum credit computed under section 2014(b)(2) of the Code shall be imposed on that part of the gross estate located in Puerto Rico.

Residents of Puerto Rico are allowed a fixed exemption (in lieu of a unified credit) in the amount of $400,000 in determining the taxable estate, reduced by the deduction taken for property located in Puerto Rico. The estates of nonresidents of Puerto Rico who were citizens of the United States generally are eligible for a fixed exemption in the amount of $10,000. However, in the case of a U.S. citizen not resident in Puerto Rico whose property in Perto Rico is not subject to estate taxation in the United States, the law provides that the allowable exemption is the greater of (a) the proportion between the value of all the gross estate of the decedent subject to taxation and the estate in both jurisdictions, multiplied by $60,000 or (b) $30,000.

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[12] If the individual is a U.S. citizen, the withholding rate is generally 20 percent

2. Taxation of corporations and partnerships

In general

Under current Puerto Rican tax law, corporations and partnerships are generally both taxed on an entity basis.[13] Such entities which are organized or created under the laws of Puerto Rico are subject to tax on their worldwide income, determined on a net profits basis.

Corporations and partnerships which are organized or created under the laws of a country other than Puerto Rico are taxed on income earned from sources within Puerto Rico and on income that is effectively connected with the conduct of a trade or business in Puerto Rico.

Puerto Rican corporations and partnerships and the effectively connected income of non-Puerto Rican corporations and partnerships are generally subject to three separate income taxes in Puerto Rico: a "normal tax" which is imposed on all taxable income at a flat rate of 22 percent, a "surtax" which is levied at graduated rates on a progressive basis, and an "additional tax" of 5 percent on certain corporations and partnerships. The benefits of the graduated rates are phased out by the additional tax beginning at $500,000 of taxable income. For taxable years beginning prior to January 1, 1989, the combined effect of the applicable taxes provided marginal tax rates that ranged from 22 to 45 percent. For taxable years beginning after December 31, 1988, the 22 percent minimum rate remains unchanged, but the maximum rate will be gradually reduced over a four-year period to 35 percent.[14]

Gains from the disposition of capital assets held for more than six months are subject to a maximum tax of 25 percent.

Affiliated Puerto Rican corporations and partnerships are not permitted to consolidate their operations for purposes of determining their Puerto Rican income tax liability. Thus, each member of an affiliated group must file a separate Puerto Rican income tax return and generally pay tax on its separate taxable income.

Non-effectively connected fixed or determinable annual or periodical income (e.g., interest, dividends, royalties, rents, wages, and annuities) that is earned from sources within Puerto Rico by non-Puerto Rican corporations and partnerships is generally subject to a gross basis withholding tax of 29 percent, except that certain specified items of such income are subject to withholding tax at reduced rates.[15]

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[13] However, certain partnerships referred to as "special partnerships" are allowed flow through treatment similar to the treatment afforded to partnerships under U.S. tax law. To qualify as a special partnership, at least 70 percent of the partnership's income must be from Puerto Rico sources and at least 70 percent of its gross income must be derived from certain specified activities.

[14] The highest marginal rate for 1989 is 42 percent, for 1990 is 39 percent, for 1991 is 37 percent, and for 1992 and beyond is 35 percent.

[15] For example, dividends are subject to withholding tax at a rate of either 10 percent (if derived from manufacturing or other specified activities) or 25 percent.

Alternative minimum tax

As part of the 1987 tax reform, a corporate alternative minimum tax was enacted that is similar, in some respects, to the U.S. corporate alternative minimum tax. The Puerto Rican corporate alternative minimum tax will apply if it results in a tax liability greater than the corporation's regular tax liability.

The corporate alternative minimum tax rate is a flat 22 percent, levied on "alternative minimum net income." Generally, alternative minimum net income is computed by adding back to taxable income certain items which receive preferential treatment in computing the regular tax. Items of tax preference include flexible depreciation (discussed in Part I.B.4.), income deferred under the installment method, and net operating losses, among others. Additionally, alternative minimum net income is increased by an amount equal to 50 percent of the excess of the corporation's net income per its audited financial statements over alternative minimum net income before this adjustment.

Branch profits tax

Puerto Rico also imposes a tax on certain profits of a Puerto Rican branch of a non-Puerto Rican corporation or partnership. The purpose of the branch profits tax is to provide similar tax treatment to Puerto Rican branches and Puerto Rican subsidiaries of non-Puerto Rican corporations and partnerships. The branch profits tax rate is generally equal to 25 percent of the branch's "dividend equivalent amount." This amount represents profits of the branch that are effectively connected with a trade or business in Puerto Rico, and that are not reinvested in such a trade or business.

The branch profits tax rate is only 10 percent for manufacturing, hotel, and shipping operations; and the tax is inapplicable to non-Puerto Rican corporations and partnerships that derive at least 80 percent of their gross income from Puerto Rico sources.[16]

In addition to the branch profits tax, a special 29 percent branch-level interest tax is levied on the excess of the amount of interest deducted by a Puerto Rican branch over the amount of interest it actually paid during the taxable year.

3. Foreign tax credit

Non-Puerto Rican taxes paid by a Puerto Rican corporation, Puerto Rican partnership, or individual resident in Puerto Rico on non-Puerto Rico source income can be claimed as a credit against Puerto Rican tax on such income. This credit, however, is subject to a per-country limitation and an overall limitation. Alternatively, non-Puerto Rican taxes may be claimed as a deduction against gross income in arriving at taxable income.

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[16] This exemption from the branch profits tax generally covers U.S. corporations that claim benefits under Code section 936.

4. Tax incentives

In general

The Puerto Rican tax law provides numerous tax incentives intended to encourage capital formation and attract foreign investment. Many of these incentives are available to sole proprietorships, as well as to corporations and partnerships.

Industrial tax incentives

The Puerto Rico Tax Incentives Act of 1987 provides for a partial tax exemption for corporate income and property taxes. Generally, taxpayers engaged in manufacturing or that provide export services are allowed 90-percent tax exemptions on their industrial development income. The length of time for which a taxpayer may qualify for this incentive depends on the location of the taxpayer's qualified operation, as set forth in the following table.

Investment in:	*[Exemption is applicable for]* *Years*
High Industrial Zones	10
Intermediate Industrial Zones	15
Low Industrial Zones	20
Vieques and Culebra [17]	25

An eligible taxpayer is permitted to elect specific taxable years to which the exemption would apply. For example, if an eligible taxpayer incurs a net operating loss during the first taxable year in which it qualifies for the exemption, it could elect not to apply the exemption for that year and still have the full exemption period remaining. Following the expiration of the applicable exemption period, manufacturing firms may apply for an additional ten years of exemption at a 75-percent exemption rate.

A manufacturing operation that qualifies under the tax incentive system and that has income of less than $500,000 and employs more than 15 persons generally is granted a 100-percent tax exemption on the first $100,000 of such income. In lieu of this exemption, certain manufacturing companies are allowed a deduction equal to 15 percent of their production worker payroll, not to exceed 50 percent of industrial development income.

Other tax incentives which are made available to manufacturing firms include a reduced tax of 5 percent on the repatriation of one-half of current earnings by a Puerto Rican corporation to a non-Puerto Rican shareholder if the other half is invested for at least five years in designated Puerto Rican assets.[18]

Puerto Rico also provides incentives to certain financial institutions referred to as "International Banking Entities" (IBEs). Generally, income earned by an IBE from authorized activities is completely exempt from income and branch profits tax. Also, distributions of such earnings to owners of the IBE are exempt from all withholding tax.

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[17] Offshore islands.

[18] After the expiration of the five-year period, the reinvested earnings may also be repatriated, subject to a 5-percent tax.

Taxpayers in other specified industries also are eligible for varius tax incentives. The favored industries include shipping, agriculure, tourism, art and literature. Generally, the incentives are proided by means of special tax exemptions or deductions that vary y industry.

Flexible depreciation

As a general rule, a taxpayer is permitted to claim depreciation leductions for the cost of a capital asset over the asset's estimated iseful life. Depreciation is usually claimed either on a straight-line asis or on any other basis in accordance with a recognized trade practice.

However, in certain circumstances, taxpayers are entitled to claim depreciation deductions on an accelerated system known as "flexible depreciation." Flexible depreciation may be claimed by taxpayers with income from construction, agriculture, land development, real estate rehabilitation, real estate development, manufacturing, hotel, tourism, shipping, and certain export operations. Under the flexible depreciation system, a taxpayer may elect to depreciate all, part, or none of the undepreciated cost of the qualifying asset during the taxable year. The deduction is limited, however, to an amount not to exceed 100 percent of the pre-depreciation net income of the qualified activity for the taxable year.

For example, assume a taxpayer engaged in manufacturing has pre-depreciation net income for the taxable year of $100,000, and has manufacturing equipment with an undepreciated basis of $200,000. Further assume that under the general depreciation system, the taxpayer would receive a depreciation deduction in the amount of $20,000. Under the flexible depreciation system, the taxpayer is permitted to claim up to $100,000 of depreciation, thereby reducing its taxable income to zero.

C. U.S. Internal Revenue Code Section 936

As described above, a U.S. domestic corporation is subject to U.S. Federal income tax on its worldwide income. Generally, a foreign corporation is subject to U.S. income tax only with respect to its income derived from sources within the United States or income which is effectively connected with the conduct of a trade or business in the United States. For this purpose, a domestic corporation is one created or organized under U.S. or State law, and the term "United States" generally includes only the 50 States and the District of Columbia. Any other corporation is a foreign corporation. For example, a corporation organized under Delaware corporate law and doing business solely in Puerto Rico is a domestic corporation and is therefore generally subject to U.S. tax on its Puerto Rican income; by contrast, a corporation organized under the laws of Puerto Rico, and engaged in the same business as the Delaware corporation in Puerto Rico, is a foreign corporation and is subject to no U.S. tax.

A domestic corporation in certain circumstances may eliminate its U.S. tax on certain income associated with certain possessions (including Puerto Rico) and certain foreign countries by means of the possessions tax credit under section 936 of the Internal Revenue Code. In effect, this credit may eliminate all income tax on a domestic corporation doing business in Puerto Rico where the corporation is also excused from Puerto Rican income tax pursuant to a tax incentive provided under Puerto Rican law as described above.

1. Qualification requirements

In order to qualify for the possessions tax credit, a domestic corporation must satisfy the following two requirements. First, the corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession (which can include the Commonwealth of Puerto Rico) during the preceding three years.[19] Second, at least 80 percent of the gross income of the corporation must be derived from sources within a U.S. possession during that same three-year period. A domestic corporation which satisfies these requirements and elects the benefits of section 936 is generally referred to as a "qualified possessions corporation" or a "section 936 corporation."

2. Operation of the credit

General rule

As described above, a qualified possessions corporation, like any other domestic corporation, is generally subject to U.S. taxation on its worldwide income. However, section 936 allows such a corporation a credit equal to the portion of its U.S. tax liability that is attributable to (1) foreign source taxable income from the conduct of an active trade or business within a U.S. possession or the sale or exchange of substantially all of the corporation's assets which were used in such a trade or business, and (2) certain income earned from investments in U.S. possessions or certain foreign countries, generally referred to as qualified possession source investment income ("QPSII").

To illustrate the operation of the section 936 credit, consider the following examples. Assume that a qualified possessions corporation which has elected the use of the section 936 credit earns $80 of foreign source taxable income from the active conduct of a trade or business in Puerto Rico, and $20 of QPSII (also foreign source) during the taxable year. Further assume that the corporation earns no additional income. Absent the section 936 credit, the corporation would have a U.S. tax liability of $34.[20] However, section 936 allows a tax credit equal to the portion of tentative U.S. tax attributable to Puerto Rico-related income. Since all of the corporation's taxable income for the year was derived from an active business conducted in Puerto Rico or from QPSII, the credit eliminates the corporation's entire U.S. tax liability for the year.

Now assume that the same company earned an additional $20 from U.S. sources during the taxable year. In this case, the corporation's U.S. tax liability prior to application of the credit would be $40.80.[21] Because $100 of the corporation's taxable income was possession source income which qualifies for the credit, the credit would reduce the corporation's U.S. tax liability to only $6.80.[22]

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[19] The majority of corporations that currently qualify for the section 936 credit have established operations in Puerto Rico.

[20] $100 multiplied by the current corporate tax rate of 34 percent.

[21] $120 x .34 = $40.80.

As this description indicates, the section 936 credit, unlike the ordinary foreign tax credit, is a "tax-sparing" credit. That is, the foreign tax credit is applicable only where a U.S. corporation has actually paid or accrued a foreign tax liability with respect to income earned from non-U.S. sources. The foreign tax credit operates as a mechanism to prevent double taxation of the same item of foreign source income. By contrast, the section 936 credit is not contingent on taxation in the possession, but spares the section 936 corporation U.S. tax whether or not it pays income tax to the possession. In fact, qualified possessions corporations are typically granted full or partial exemptions from Puerto Rican income taxes under the tax incentive programs described above. Therefore, the section 936 credit often allows corporations to earn income that is subject to little or no income tax by any jurisdiction.

Taxation of intangible property income

Prior to enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), many U.S. companies took the position that they could utilize qualified possessions corporations to generate tax-free income from any intangible property that had been developed in the United States by such U.S. companies. To achieve this result, a U.S. company would transfer developed intangible property to a wholly owned qualified possessions corporation. That transfer would generally be free of U.S. tax under Code section 351. The qualified possessions corporation would, in turn, use the intangible property in its Puerto Rican manufacturing operations. Profits attributable to the intangible property would be recognized by the qualified possessions corporation upon sale of its manufactured product. Taxpayers argued that because such profits were attributable to an active business conducted in Puerto Rico, they were eligible for the section 936 credit and could escape U.S. taxation. These positions were the subject of considerable disagreement between taxpayers and the U.S. government.

In response to the issues associated with the transfer of intangible property developed in the United States, the Congress in TEFRA added sections 367(d) and 936(h) to the Code. Section 367(d) provides special rules which generally treat the transfer of intangible property by a U.S. person to a foreign person in an otherwise tax-free exchange or reorganization as a taxable sale of such property, the sales price of which is contingent on the future income to be generated by the intangible property. The resulting income is treated as having a U.S. source. Section 936(h) provides rules for allocating income from intangible property between a qualified possessions corporation and its U.S. shareholders. Three alternative methods are provided for allocating intangible property income. These methods include (1) a general rule, (2) a cost sharing method, and (3) a profit split approach. Under the general rule, a qualified possessions corporation is prohibited from earning any return on intangible property. Instead, all such income must be allocated to its U.S. shareholders. However, a qualified possessions corporation may elect to use either the cost sharing or profit split method instead of the general rule.

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[22] $40.80 x ((120-100)/120) = $6.80.

The operation of the cost sharing and profit split methods was revised by the Tax Reform Act of 1986. Relevant 1986 Act revisions included both direct amendments to section 936(h) and also amendments to section 482. Insofar as amounts computed under either method were determined by reference to the meaning of "arms length" as used in section 482, these methods were affected by the requirement, added by the 1986 Act, that the income with respect to any transfer or license of intangible property shall be "commensurate with the income attributable to the intangible."

Currently under the cost sharing method, a qualified possessions corporation must pay to the appropriate members of its affiliated group (which includes foreign affiliates) an amount representing its current share of the costs of the research and development expenses incurred by the affiliated group. A qualified possessions corporation's current share of the affiliated group's research and development expenses is the greater of (1) the total amount of such expenses, multiplied by 110 percent of the proportion of its sales as compared to total sales of the affiliated group, or (2) the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangibles which the qualified possessions corporation is treated as owning under the cost sharing option, were the latter a foreign corporation (whether or not intangibles actually are transferred to the qualified possessions corporation). By making this cost sharing payment, the qualified possessions corporation becomes entitled to treat its income as including a return from certain intangibles, primarily manufacturing intangibles, associated with the products it manufactures in the possession.

Under the profit split method, the qualified possessions corporation and its U.S. affiliates are permitted to split their combined taxable income derived from sales of products which are manufactured in the possession by the qualified possessions corporation. Generally, 50 percent of this combined taxable income is allocated to the qualified possessions corporation. However, a special allocation of research and development expenses as required by section 936(h)(5)(C)(ii)(II) can cause the proportion of combined taxable income allocated to the qualified possessions corporation to be less than 50 percent. In no event under the profit split approach will the portion of combined taxable income which is allocable to the qualified possessions corporation exceed 50 percent.

As a result of the 1986 Act provision that requires the amount of a cost sharing payment to be determined in accordance with the rules of section 367(d), some taxpayers previously utilizing that method may find that they are no longer able to claim as much section 936 credit against U.S. tax on income attributable to intangible property under that method as they would be able to claim using the profit split method. As a result, some taxpayers may find the cost sharing method less desirable and may switch to the profit split approach, as permitted by I.R.S. Notice 87-27, 1987-1 C.B. 471. Because Treasury has yet to issue certain guidelines applicable to the relevant computations, the time for making such a switch has been extended by I.R.S. Notice 88-97, 1988-2 C.B. 421, and I.R.S. Notice 89-82, 1989-32 I.R.B. 54.

Alternative minimum tax

Income earned by a qualified possessions corporation that qualifies for the section 936 credit is excluded from alternative minimum taxable income, and therefore is not subject to the alternative minimum tax.

Taxation of distributions to shareholders of qualified possessions corporations

A qualified possessions corporation is not permitted to join in filing a consolidated U.S. tax return. Therefore, dividends paid by the qualified possessions corporation to its U.S. shareholders are not eliminated under the rules applicable to affiliated groups of corporations that file tax returns on a consolidated basis. However, such dividends may qualify for the deduction for dividends received from a domestic corporation (sec. 243). In the case of a corporate shareholder that owns at least 80 percent of a qualified possessions corporation, 100 percent of dividends received from such corporation generally are deductible by the shareholder. For corporate shareholders owning less than 80 percent of a qualified possessions corporation, a 70-percent dividends received deduction is available. Consistent with the benefits provided by the dividends received deduction to corporate shareholders of qualified possessions corporations, non-corporate taxpayers rarely own the stock of qualified possessions corporations. Such corporations are generally owned by U.S. corporations with sufficient stock ownership to qualify for the 100-percent dividends received deduction. Thus, in most cases, income earned in Puerto Rico by a qualified possessions corporation can be distributed to a U.S. corporate shareholder without incurring any regular U.S. income tax, either to the qualified possessions corporation or to the U.S. corporate shareholder. However, the dividend constitutes adjusted current earnings of the U.S. corporate shareholder for purposes of computing the alternative minimum tax.

Earnings on funds invested by a U.S. corporation are generally subject to U.S. tax. On the other hand, undistributed retained earnings of a qualified possessions corporation which are invested in Puerto Rico (or, indirectly, in certain foreign countries) generally produce QPSII, which is not subject to U.S. tax. As a result, there appears to be little incentive for a qualified possessions corporation o repatriate earnings to the United States (except to the extent hat the corporation would otherwise fail to meet the 75-percent ctive business test) when tax-free income can be earned by investng such amounts elsewhere.

D. Excise Taxes

U.S. excise taxes

The Internal Revenue Code imposes a variety of excise taxes on e manufacture, sale or use of particular commodities or services. cupational taxes and penalty taxes imposed on certain other acities (e.g., prohibited transactions of tax-exempt entities) are also provided as excise taxes. Many excise taxes are collected at the manufacturing level or, in the case of commodities produced abroad, upon importation. Other excise taxes are collected at the wholesale or retail level. (Certain Federal excise taxes imposed under the Internal Revenue Code are listed in Appendix A.)

U.S. excise taxes generally do not apply within Puerto Rico.[23] However, a special excise tax is imposed on articles which are manufactured in Puerto Rico and shipped into the United States for sale or consumption. The tax is equal to the Federal excise tax that would be imposed if the articles were manufactured in the United States (sec. 7652).[24]

Revenues collected from the tax on articles coming into the United States from Puerto Rico are generally "covered over" (i.e., paid) to the Puerto Rican Treasury. With respect to excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States (sec. 7652(d)(1)). Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article that is unlike the subsidies Puerto Rico generally offers to industries producing articles not subject to Federal excise tax (sec. 7652(d)(2)).

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rican Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum (sec. 7652(c)). The amount of excise taxes covered over to Puerto Rico with respect to such articles cannot exceed $10.50 per proof gallon (sec. 7652(f)).

In addition, a provision of the Code added by the Caribbean Basin Initiative (described in Part I.F., below) provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the treasuries of Puerto Rico and the U.S. Virgin Islands, under a formula prescribed by the U.S. Treasury Department for the division of such tax collections between Puerto Rico and the Virgin Islands (sec. 7652(e)).[25] This formula currently results in the cover over of approximately 88 percent of revenues from rum excise taxes to Puerto Rico and the remainder of such revenues to the Virgin Islands.

A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico (sec. 7653). In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rican manufacture.

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[23] *See* 48 U.S.C. sec. 734 (1982).

[24] No tax is imposed, however, with respect to distilled spirits manufactured in Puerto Rico and brought into the United States for certain nonbeverage purposes, as provided for by section 5314.

[25] The formula for division of rum excise taxes between Puerto Rico and the Virgin Islands is contained in 27 C.F.R. part 250.31 (1988).

2. Puerto Rico excise taxes

Puerto Rico generally imposes a 5 percent excise tax on a broad range of commodities, transactions, and occupations, with special excise tax rates for certain articles such as sugar, cigarettes, and petroleum products.[26] (Selected Puerto Rican excise tax rates are listed in Appendix B.) Articles manufactured in Puerto Rico and exported therefrom are exempt from Puerto Rican excise taxes, as are articles introduced by importers and deposited in bonded warehouses for reexportation. In addition, certain enumerated items (e.g., food, religious items, certain farm equipment, books, magazines, newspapers, children's clothes, and various personal and medical items) are exempt from Puerto Rican excise taxes.

E. Tax Treaties

In addition to the Federal, State, and local tax laws contained in the Internal Revenue Code and other statutes, tax rules governing U.S. persons, or U.S. income, may also be determined by bilateral or other treaty obligations between the United States and foreign countries. Generally, the purposes of such treaties are the avoidance of double taxation and the prevention of fiscal evasion.

Treaties accomplish the goal of avoiding double taxation by limiting the amount of tax that may be imposed by one treaty country on the income earned by residents of the other treaty country, by ensuring the creditability of taxes imposed by the treaty country where income was earned (the "source country") in computing the amount of tax owed by a resident of the other treaty country to his or her residence country (or by exempting from residence country tax income derived from sources in the other treaty country), and by providing procedures under which inconsistent positions taken by both treaty countries with respect to a single item of income or deduction may be mutually resolved by the two countries. Treaties prevent fiscal evasion by providing for exchange of taxpayer information between the two taxing authorities, and in some cases by providing that each tax authority will assist the other in revenue collection. In addition, treaties typically provide that nationals of one treaty country may not be subject by the other treaty country to taxes or requirements connected therewith that are other or more burdensome than those applicable to similarly situated nationals of the other treaty country. Generally, treaties may be used by residents or citizens of one country to reduce the taxes that would otherwise be payable to the other country under its internal laws. Treaties generally do not operate to increase the amount of taxes that would otherwise be due under internal law.

The United States is currently a party to over 35 bilateral income tax treaties, over 15 estate and gift tax treaties, approximately five agreements for the exchange of taxpayer information, and certain other treaties (e.g., friendship, commerce, and navigation treaties) that may affect tax relations with residents or nationals of other countries. The preferred tax treaty policies of U.S. Administrations have been expressed from time to time in model treaties and agreements. In addition, the Organization for Economic

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[26] *See* 1987 Commonwealth of Puerto Rico Excise Act

Cooperation and Development and the United Nations have published model tax treaties.

Other countries' preferred tax treaty policies may differ from those of the United States depending on their internal tax laws and depending upon the balance of investment and trade flows between those countries and their potential treaty partners. For example, the United States has in the past attempted to negotiate treaties that waive all source country tax on interest, royalties, and personal property rents paid to residents of the other treaty country. Certain capital importing countries, on the other hand, may be interested in imposing relatively high source country tax on such income. In cases where a country taxes certain local business operations at a relatively low rate, or a zero rate of income tax (whether to attract manufacturing capital to that country or for other reasons), that country may seek to enter into "tax-sparing" treaties with capital exporting countries. That is, the first country may seek to enter into treaties under which the capital exporting country gives up its tax on the income of its residents derived from sources in the first country, regardless of the extent to which the source country has imposed tax with respect to that income.[27] However, the United States has rejected proposals by certain foreign countries to enter into such tax sparing arrangements.[28]

There are no bilateral tax treaties between Puerto Rico and any foreign country. In addition, U.S. treaties typically do not include Puerto Rico in the definition of "United States" for treaty purposes. Moreover, although Puerto Rican individuals are typically U.S. citizens, U.S. treaties often do not extend to them the same reductions of foreign source country tax to which a resident of one of the 50 States or the District of Columbia would be entitled under a U.S. tax treaty.

F. Caribbean Basin Initiative

The Caribbean Basin Economic Recovery Act (title II of Pub. L. No. 98-67, 97 Stat. 369 (1983), also known as the Caribbean Basin Initiative, or "CBI") provides for an integrated, mutually reinforcing set of measures in the fields of trade, tax, investment, and financial assistance to address both emergency problems and long-range economic development among the countries of the Caribbean basin. The Act lists 27 countries that each may be treated as a beneficiary country under the CBI if there is in effect a proclamation by the President designating such country as a beneficiary country.[29] The CBI provides that the President may not make such a

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[27] For a statement of some of the policies implicated by tax sparing, see, e.g., *Double Taxation Convention with Pakistan: Hearing before the Senate Comm. on Foreign Relations*, 85th Cong., 1st Sess. 1-34 (1957) (testimony of Professor Stanley Surrey).

[28] By contrast, the United States has provided, through section 936 of the Code, for "tax-sparing" with respect to certain Puerto Rican source (and other possession source) income of U.S. companies.

[29] The countries listed in the CBI are the following:

Anguilla
Antigua and Barbuda
The Bahamas
Barbados
Belize
British Virgin Islands
Cayman Islands
Costa Rica
Dominica
Dominican Republic
El Salvador
Grenada

Continued

designation, or must withdraw the designation, under certain enumerated circumstances inimical to U.S. public policy in the region. Currently, 22 countries have been designated.[30]

The CBI contains provisions to ensure that Puerto Rico and other U.S. possessions not suffer from the benefits conferred on beneficiary countries under the CBI. For example, insofar as favorable duties on rum imported into the United States from beneficiary countries might have reduced the quantity of Puerto Rican rum imported into the United States, and hence reduce the cover over to Puerto Rico of rum duties under Code section 7652(a), the CBI provides (as described above in Part I.D.) for a cover over to Puerto Rico of rum duties collected from other countries as well, under a formula to be prescribed by the Treasury.

Expenses for attending conventions outside the "North American area" are not deductible unless certain conditions are met. The term "North American area" includes the United States, its possessions, and the Trust Territory of the Pacific Islands, and Canada and Mexico. Under the CBI, the term also includes any CBI beneficiary country, or Bermuda, if there is in effect a bilateral or multilateral agreement between such country and the United States providing for the exchange of information between the United States and such country, and there is not in effect a finding by the Treasury that the tax laws of such country discriminate against conventions held in the United States. Currently, the countries that qualify for this treatment include Bermuda, Jamaica, Grenada, Dominica, Barbados, and the Dominican Republic.

Guatemala
Guyana
Haiti
Honduras
Jamaica
Montserrat
Netherlands Antilles
Nicaragua
Panama
Saint Christopher-Nevis
Saint Lucia
Saint Vincent and the Grenadines
Suriname
Trinidad and Tobago
Turks and Caicos Islands

See 19 U.S.C. sec. 2702(b) (1988).

[30] The designated countries are the following:
Antigua and Barbuda
Aruba
The Bahamas
Barbados
Belize
British Virgin Islands
Costa Rica
Dominica
Dominican Republic
El Salvador
Grenada
Guatemala
Guyana
Haiti
Honduras
Jamaica
Montserrat
Netherlands Antilles
Saint Christopher-Nevis
Saint Lucia
Saint Vincent and the Grenadines
Trinidad and Tobago
See Tariff Schedules of the United States, 19 U.S.C.A. sec. 1202 (1988).

Countries that enter into an information exchange agreement under the CBI are eligible to serve as host countries for Foreign Sales Corporations ("FSCs"), which are entitled to special tax benefits under the Code. In addition, certain investments in CBI countries that qualify for convention deductions may generate qualified possessions source investment income for purposes of the possession tax credit of section 936 when investments in a financial institution or the Government Development Bank for Puerto Rico or the Puerto Rico Economic Development Bank are used for investment consistent with the goals and purposes of the CBI in active business assets or development projects in those CBI countries.

II. DESCRIPTION OF THE BILL (S. 712)

A. Overview

The bill (S. 712) as reported by the Senate Committee on Energy and Natural Resources,[31] provides for a referendum to be held on June 4, 1991 (and if necessary for a runoff referendum to be held on August 6, 1991), or on a date (or dates) during the summer of 1991 as may be mutually agreed by the three principal political parties of Puerto Rico. The purpose of the referendum will be to determine whether Puerto Rico is to become a U.S. State, become an independent country, or remain in a Commonwealth relationship with the United States.[32] The procedures for implementing whichever status option receives a majority (as certified to the President and the Congress of the United States by the Governor of Puerto Rico) are detailed in titles II (which applies if statehood is chosen), III (independence), and IV (commonwealth) of the bill. The bill provides that the set of procedures appropriate to implement the status chosen generally shall go into effect on October 1, 1991. Moreover, in the event of a delay due to a legal challenge, implementation of the status option receiving a majority is intended to go into effect as soon as is practicable after October 1, 1991 (S. Rep. No. 101-120, at 31).

As discussed below, titles II and III of the bill contain provisions regarding tax and other economic issues that arise under the options providing for a change from Puerto Rico's current status. The report of the Committee on Energy and Natural Resources states that the committee intended to establish three principles to guide future consideration of the bill:

> These principles include: first, that there ought to be an even playing field, politically, between the three political parties with regard to the status options; second, that there ought to be a smooth transition so that any change in political status, to statehood or independence, ought to work economically; and third, economic adjustment should be revenue-neutral to the extent possible, in that it does not cost the Treasury additional dollars over a period of time.[33]

As the report also states, specific concerns were expressed as to whether the committee had in fact achieved an even playing field. The one specific concern identified in the report is not a tax issue, however, but rather that there is a tilt toward statehood because there are a number of Federal benefit programs on which, effective January 1, 1992, the existing Federal "caps" on benefits would be eliminated and recipients of these program benefits might thus be encouraged to vote for statehood (*id.*).

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[31] S. Rep. No. 101-120, 101st Cong., 1st Sess., September 26, 1989.

[32] The bill describes Puerto Rico, under the Commonwealth relationship, as a self-governing body politic joined in political relationship with the United States and under the sovereignty of the United States (bill sec. 402).

[33] S. Rep. No. 101-120, at 26.

B. Statehood

Should statehood be certified as having obtained a majority of the votes cast in the referendum, and upon the certification of the election of officers (U.S. Senators and Representatives) required under the bill, then the President is to issue a proclamation announcing the result of the election, and admitting the Commonwealth of Puerto Rico as a State on an equal footing with the other States (bill sec. 201). Upon admission of Puerto Rico into the Union, all of the local laws then in force in Puerto Rico continue in force and effect (except as modified or changed by the bill) subject to repeal or amendment by the Puerto Rico legislature (bill sec. 208(a)).

As a general rule, all of the laws of the United States will have the same force and effect within the State as they had on the date immediately prior to the date of admission of the State of Puerto Rico, subject to certain important exceptions (*id.*). For example, the continuation of laws in effect does not apply to existing laws providing for grants or other assistance to State or local governments or to individuals, under which Puerto Rico or its residents are either excluded or whose eligibility is less than that provided on a uniform basis to other States.

Under section 213 of the bill, entitled "Economic adjustment," the bill contains a set of transitional provisions which, according to the language of the bill, are intended to be

> Pursuant to Congress's power to admit new States, in recognition of the unique Federal tax provisions and programs affecting the Commonwealth of Puerto Rico which differ from those which applied to any other newly admitted State, and solely for the purposes of effecting a smooth and fair transition for the new State with a minimum of economic dislocation and to permit Federal agencies to assume or expand responsibilities for the administration and enforcement of Federal taxes and programs affecting the citizens residing in the new State.

The transitional provisions relate specifically to excise taxes, to income taxes, to the payment of Federal tax receipts and customs duties and equivalency payments on alcohol to Puerto Rico after statehood, and to the application in Puerto Rico of Federal entitlement programs (such as Aid to Families with Dependent Children (AFDC), Medicaid, Medicare, and the Food Stamp Program, among others). This pamphlet addresses the first three topics.

With respect to excise taxes, all Federal excise taxes which are not applicable to Puerto Rico as a possession are extended to Puerto Rico, effective on the date of admission of Puerto Rico to statehood, in the same manner as otherwise applicable in the several States (bill sec. 213(a)). It is apparently intended that with respect to other taxes, the current tax treatment applicable to Puerto

Rico is continued until January 1, 1994 (bill sec. 213(d)).[34] Effective on that date, the Federal internal revenue laws would apply generally within the State of Puerto Rico as within the several States, subject to such transitional rules or other provisions as Congress may have enacted prior to that date. However, the bill provides that the tax credit previously allowed under section 936 of the Code with respect to income or investments from activity in Puerto Rico would be reduced to 80 percent for taxable years beginning in 1994, 60 percent for taxable years beginning in 1995, 40 percent for taxable years beginning in 1996, 20 percent for taxable years beginning in 1997, and would not be available with respect to such income or investments thereafter. The bill expressly reserves to Congress authority to enact appropriate transitional rules regarding the implementation of the above credit reductions and the tax treatment of corporations with respect to which a section 936 election is in effect during the transition period. The bill would also authorize the Treasury Department to promulgate and implement such regulations as are necessary.

Further, the bill would provide certain grants and other payments to Puerto Rico based on tax revenues. The current payment provided by permanent indefinite appropriations of customs duties and equivalency payments on alcohol would be continued as a statehood grant (bill sec. 213(e)(1)). Unless otherwise provided by law, all revenues derived from Federal excise taxes which became applicable in the State of Puerto Rico pursuant to the bill, or any new Federal excise taxes which become applicable thereafter, would be deposited into the Treasury of Puerto Rico (bill sec. 213(e)(2)). The bill provides that, "[a]s a compact with the State of Puerto Rico," no alteration in the transfer of funds under this provision or the above provision on customs duties and equivalency payments on alcohol may be made until after October 1, 1998. The bill would not change the rule that prevents the cover over to Puerto Rico of amounts in respect of taxes imposed on any article (other than an article containing distilled spirits) if the U.S. Treasury determines that a Federal excise tax subsidy was provided by Puerto Rico with respect to such article. That is, as under current law, cover over will be prevented if Puerto Rico provides any subsidy of a kind different from, or in an amount per value or volume of production greater than, the subsidy which Puerto Rico offers generally to industries producing articles not subject to Federal excise taxes.

Finally, the bill provides that all revenues derived from the application of the Federal internal revenue laws in 1994 and 1995 within the State of Puerto Rico would be deposited into the Treasury of Puerto Rico as a transitional statehood grant to the new State to assist in maintenance of government services and infrastructure, and to minimize the impact on local revenues of the transition from being a foreign tax jurisdiction (bill sec. 213(e)(3)). The measure of the amount of income which is so derived would be bill).[35] The annual grants would begin in the fiscal year following the year independence is proclaimed and be made through the ninth year following the certification of the status referendum.

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[34] A technical change might be appropriate to clarify the intent of the Committee on Energy and Natural Resources. It may be likely that, for excise tax purposes, the specific rule provided for by bill section 213(a) would control, rather than the more general rule of bill section 213(d).

The bill provides that once the results of the referendum are certified (that is, before actual independence), Puerto Rico would no longer be deemed to be a part of the United States for the purposes of acquiring citizenship of the United States by place of birth. In addition, no person born outside of the United States after the proclamation of independence would be a citizen of the United States at birth if the parents of such person acquired U.S. citizenship (under now-existing law) solely by virtue of being born, prior to the proclamation of independence, in Puerto Rico. The bill does not affect the citizenship, however, of any person born prior to the date of the certification of the referendum. Also, the bill provides various rights under U.S. immigration laws for Puerto Rican individuals who were born after independence or certification of the referendum or who otherwise never were U.S. citizens.

The bill provides for three specific measures relating to Federal taxes. First, effective on the date of proclamation of independence, the tax credit allowed under Code section 936 would become unavailable with respect to income or investments from activity in Puerto Rico (bill sec. 317(a)). Second, the bill would provide for the establishment of a task force by the Joint Transition Commission that would be charged with negotiating appropriate tax treaties to govern relations between the United States and Puerto Rico, which agreements would be approved by the government of Puerto Rico and the United States in accordance with their respective constitutional processes (bill sec. 317(b)). Finally, while the bill provides that the outstanding debts of the Commonwealth of Puerto Rico at the time of the independence proclamation shall be assumed by the Republic, the bill also provides that the tax treatment of any such obligations shall be unaffected by the proclamation of independence "to the extent that similar obligations issued by states are so treated" (bill sec. 319).

Section 316(b) of the bill provides for the establishment of a Task Force on Trade to consider and develop specific provisions between the United States and Puerto Rico following independence. This subsection also expresses Congress's willingness to consider a mutual free trade arrangement if negotiated. According to the report of the Committee on Energy and Natural Resources, "free-trade" in this case

> Does not mean that there would be open trade of all goods between the two nations, but that to the extent there are limitations on imports or exports, those limitations would be as mutually agreed and would, overall, provide mutual benefits to each nation and would assist each in meeting its trade and economic development objectives.[36]

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[35] A technical change might be necessary to clarify the intent of the Committee on Energy and Natural Resources. The bill seems to provide that the grant will equal the Comptroller General's estimate of the total *number* of grants, programs, and services discontinued, rather than the total *amount* of such discontinued grants, programs and services.

[36] S. Rep. No. 101-120, at 46-47.

determined according to such transitional rules or other provisions as Congress may have enacted prior to January 1, 1994.

In addition to the foregoing express transitional rules, the bill would require various studies aimed at determining what changes in Federal laws applicable to Puerto Rico, or in the administration of those laws, would be appropriate after statehood (e.g., bill secs. 208(b) and 213(b)).

C. Independence

Should independence be certified as having obtained a majority of the votes cast in the referendum, the bill provides for the Puerto Rico legislature to set in motion the election of delegates to a constitutional convention, and, after a constitution is adopted by the convention, an election by the people for its ratification or rejection. In addition, the bill provides for the establishment of a Joint Transition Commission to be appointed in equal numbers by the President of the United States and the presiding officer of the constitutional convention.

The bill provides for the President of the United States to recognize Puerto Rico's independence by proclamation shortly after (1) the Governor of Puerto Rico certifies the results of an election of officers of the Republic of Puerto Rico called for under the ratified constitution, and (2) the approval, in accordance with the constitutional processes of Puerto Rico and the United States, of specific arrangements for (a) the use of military areas by the United States in Puerto Rico, and to meet United States defense interests, and (b) the continuation or phaseout of Federal programs. The bill provides that U.S. recognition of independence would take effect as of a date chosen by the presiding officer of the constitutional convention (with the advice of the person elected as head of state of the Republic), shortly after receipt of the U.S. proclamation recognizing Puerto Rican independence, on which date the government of the Republic would take office. The bill provides for a proclamation of independence to be made by the Puerto Rican head of state immediately upon taking office. The bill also provides that upon the proclamation of independence, all U.S. laws applicable to the Commonwealth of Puerto Rico immediately prior to the proclamation shall no longer apply in the Republic of Puerto Rico, unless specifically otherwise stated.

The arrangements regarding military areas and Federal programs are to be negotiated by task forces established by the Joint Transition Commission, and would be required under the bill to accomplish certain goals. For example, the arrangements for continuation or phaseout of Federal programs must provide that all Federal pension programs shall continue as provided by U.S. law. Under the bill, the United States may be required to pay annually to the Republic of Puerto Rico a grant equal to the amount estimated by the Comptroller General of the United States based on the total amount of grants, programs, and services, including Medicare, provided by the Federal Government in Puerto Rico in the year in which independence is proclaimed (except for those grants, programs, and services, which will otherwise continue under the

In the absence of such an agreement, the bill provides that Puerto Rico shall be afforded most favored nation status, and, provided that Puerto Rico meets the requirements under the CBI, designation as a beneficiary under the CBI.

D. Commonwealth

Should commonwealth be certified as having obtained a majority of the votes cast in the referendum, new provisions relating to the commonwealth status of Puerto Rico would become effective October 1, 1991. The bill would generally amend the rules of both the House and the Senate to expedite review of certain recommendations of the Puerto Rican government (where such recommendations are adopted by the Puerto Rico legislature and that fact is certified by the Governor to the Speaker of the U.S. House of Representatives and the President of the Senate) that particular Federal laws should not apply to Puerto Rico (bill sec. 403(a) and (b)). Under the bill, such a recommendation becomes law through enactment of a joint resolution of Congress approving the recommendation. (This provision would not apply, however, to any Federal statutory law (1) establishing grants or services to individual U.S. citizens, (2) relating to citizenship, or (3) pertaining to foreign relations, defense, or national security (bill sec. 403(c)).) Under the rule changes provided by the bill, if a resolution covered by the bill is introduced in the House or Senate, then it must be referred to committee, and absent a report by the committee by the end of 45 days after referral, it shall be in order for a member favoring the resolution to move to discharge the committee from further consideration. The bill sets conditions on the consideration and debate of this motion, as well as the consideration and debate of the underlying resolution, in the latter case limiting debate to not more than 10 hours, equally divided.

The bill also sets forth a mechanism under which the Governor of Puerto Rico could require agency review and judicial review of Federal regulations which apply to Puerto Rico but which the Governor determines are inconsistent with the policy, set forth in the bill, of enhancing the Commonwealth relationship to enable the people of Puerto Rico to accelerate their economic and social development, to attain maximum cultural autonomy, and in matters of government to take into account local conditions in Puerto Rico (bill secs. 402(b) and 404).

The bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States (bill sec. 403(d)). The bill also would give Puerto Rico the right (confined by the limits of U.S. international obligations) to impose tariff duties on foreign origin products imported into Puerto Rico from outside the customs territory of the United States (bill sec. 406).

III. ANALYSIS OF THE BILL

A. Overview

In analyzing the implications of the tax policy choices for the three status options, it may be useful to have established principles by which to evaluate the options. The report of the Committee on Energy and Natural Resources identified three principles to guide consideration of the bill: an even playing field, politically, for the three political parties with regard to the status options; a smooth economic transition; and an adjustment that is revenue-neutral to the Treasury over a period of time, to the extent possible.

Other principles could be used to guide the analysis. For example, some would argue that the treatment of Puerto Rico under statehood or independence should be the same as other States or independent countries, respectively, regardless of the other effects of this treatment. Others believe that the special circumstances of Puerto Rico require continuing assistance over some term, regardless of the status chosen.

There may be conflicts in practice among certain of these principles. It may be difficult to provide for an even political playing field under the three status options while still providing for a revenue-neutral transition without substantial economic disruptions.

Certain principles suggest that the analysis of tax policy should not be made in isolation from the analysis of outlay programs. The principle of revenue neutrality (relative to present law) implies that the large increase in Federal benefits provided to Puerto Rican residents that some believe would occur under statehood, for example, would have to be offset by increased levels of Federal tax revenue derived from Puerto Rico. If a similar level of benefits were not provided to Puerto Rico under the other status options, then revenue neutrality would require a lower Federal tax burden on Puerto Rico. Thus, the amount of tax revenue derived under the various status options would differ and would depend on the level of Federal benefits provided, if revenue neutrality were to be maintained. As the incidence of changes in Federal outlays would likely differ substantially from the incidence of changes in Federal taxation as it affects Puerto Rico, the net effect on Puerto Rico's economy would also require the analysis of both changes. Also, it may be appropriate to distinguish between funds provided to the Government of Puerto Rico and funds or benefits provided to the residents of Puerto Rico.

On the other hand, one may, for certain purposes, evaluate tax policy in isolation from benefit changes. For example, the principle that Puerto Rico should be treated no differently than any other State or independent country, depending on the status chosen, suggests that the appropriate tax treatment would follow from U.S. tax treatment of the other States and countries, respectively, independent of changes in Federal outlays and benefits. Having designed tax provisions to meet tax policy goals, the level of benefits could be adjusted appropriately.

B. Statehood Provisions

1. Application to Puerto Rico of the Internal Revenue Code

General application

If Puerto Rico becomes a U.S. State, its residents would, in the ordinary course of events, become U.S. Federal taxpayers subject to the Internal Revenue Code of the United States as currently applied to inhabitants of the other 50 States. Although the bill contemplates statehood taking effect near the end of 1991, the bill provides that the current tax treatment applicable to Puerto Rico is continued until January 1, 1994. Thus, the bill contains a transitional rule which delays application of ordinary U.S. tax rules to Puerto Rican persons and provides that revenues from certain taxes applicable to the State of Puerto Rico would be provided to the Treasury of Puerto Rico during a transitional period.

The intent of the rule is in part to allow Puerto Rico additional time to amend its tax laws in order to avoid placing an otherwise extraordinary tax burden on Puerto Rican persons.[37] It can be argued that Puerto Rican taxes are likely to be reduced after statehood to the extent that prior governmental functions of the Commonwealth are assumed by the Federal government, and thus are financed by Federal taxes rather than Puerto Rican taxes. The validity of this argument turns on larger budgetary issues concerning the relative levels of Federal and State spending in Puerto Rico after statehood.

The Committee on Energy and Natural Resources has taken the position in its report that the local income tax laws of Puerto Rico are sufficiently different from U.S. Federal tax laws that immediate application of the Federal income tax laws would be unworkable (S. Rep. No. 101-120 at 36). The committee concluded that new taxes should commence at the beginning of a taxable year and that Treasury would need lead time in order to properly administer and enforce the tax laws (*id.*). On the other hand, some believe that a delay of approximately two years before application of Federal income tax laws is unnecessary or otherwise inappropriate. (See Part III.B.4., below, discussing constitutional issues raised by this provision of the bill.) The Committee on Energy and Natural Resources stated that it expected the tax-writing committees to address the issue of overall transitional requirements for application of the Federal internal revenue laws in a manner which would best provide for a smooth transition for the new State (*id.* at 36-37).

At some point in the future, however, the Federal income tax laws would apply to Puerto Rican residents in the same manner as they apply to any residents of the other 50 States and the District of Columbia. Any tax imposed by the State of Puerto Rico would constitute a State tax. As is true for other States, income and property taxes paid to the Puerto Rican government would generally be deductible for Federal tax purposes under the Code as it now reads; sales taxes would not be deductible by individuals.

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[37] Currently, local Puerto Rican taxes are said to raise approximately $2 billion in local revenues (S. Rep. No. 101-120, at 36).

Once the U.S. tax laws do take effect in 1994, under the bill there will be a two-year period during which all revenues derived from the application of the Federal internal revenue laws within the State of Puerto Rico will be deposited into the Treasury of Puerto Rico. Neither the bill nor the Energy and Natural Resources Committee report elaborates on the method by which this amount is to be measured, except to say that the measure of the amount which is so derived will be determined according to such transitional rules or other provisions as Congress may have enacted prior to January 1, 1994. Although the further statutory interpretation of this language is in one sense a question of spending (rather than taxation), in another sense the existing usages of tax laws that divide taxing jurisdiction among different governments may be viewed as informative. In the case of income tax, the amount treated as derived from application of U.S. tax law in Puerto Rico could be, for example, the revenues from Puerto Rican resident individuals and Puerto Rican corporations on their income that would not be taxed by the United States if Puerto Rico were still a Commonwealth, plus revenues from the Puerto Rico source income of foreign persons and the income of such persons effectively connected with the conduct of a trade or business in Puerto Rico. As another possibility, the amount could be revenues from income of any person effectively connected with the conduct of a trade or business in Puerto Rico. Many other variations are possible.

Individuals

The Internal Revenue Code imposes lower generally statutory rates of income tax on individual taxpayers than does the Puerto Rican tax system. In addition to rate differences, differences between specific deductions, exemptions and credits available under Federal, as opposed to Puerto Rican law, would also affect the differences in net tax liabilities before and after statehood takes full effect. The addition of Federal income tax to current Puerto Rican tax would increase the individual income tax burden in Puerto Rico. It is reasonable to expect, however, that Puerto Rico would adjust its tax system to reflect the changed fiscal responsibilities of statehood.

One important item of Federal law not currently part of Puerto Rican tax law is the refundable earned income credit. Under present Puerto Rican law, for example, for a married couple with two children, income tax may be due when income exceeds $8,600. Partly as a result of the earned income credit, in the same case under present U.S. law there would be no net income tax liability until income exceeds $15,600. Moreover, the refundable credit may result in refunds in excess of tax liability for many Puerto Rican individuals with earned income below certain levels. Because the area median family income in Puerto Rico is likely below the phaseout range of the credit (which starts at $10,240 in 1989), the maximum credit amount or a significant portion thereof may be available to a disproportionately higher percentage of Puerto Rican citizens than to those of any other State.[38]

Some have expressed concern that the combination of eligibility for Federal means-tested benefits, and the imposition of U.S. Federal individual income tax in addition to Puerto Rico tax, may discourage employment and earnings in Puerto Rico after statehood. The disincentive for employment, it is argued, would be strongest for low-wage workers. Because the average income level is lower in Puerto Rico than in any existing State, it follows that the disincentive effects may be of greater importance to the economy of Puerto Rico than of any other State.

Others point out that the U.S. income tax system provides for higher income tax thresholds than the Puerto Rico system, and thus may not have an effect on many low-income workers. To the extent that Puerto Rico reduces its level of income taxation as a result of statehood, the combined level of U.S. and Puerto Rican tax would be lower than a purely static comparison would suggest. It is possible that the new Puerto Rican state tax system would have higher income tax thresholds than the existing system, and thus the tax burden on the lower income groups would be reduced. Thus, some conclude, the income tax system under statehood would not reduce and might actually increase individual incentives for employment relative to the current situation.

The application of U.S. Federal estate and gift taxation to Puerto Rico may significantly alter the estate and gift tax consequences of transfers by Puerto Rican individuals. For example, the taxable estate of a Puerto Rican decedent may be exempt from estate and gift tax under existing Puerto Rico law, due to the exclusion for certain property located in Puerto Rico. Under the bill, such an estate would be taxable by the United States if the individual dies after 1993. The "soak-up" tax under current Puerto Rico law may or may not be viewed as also imposing a tax on such an estate after 1993, and that tax, if not amended, might affect not only the division of the revenue generated by taxing the estate between the State and Federal governments, but in addition the total amount of tax owed on the estate. It may be that Puerto Rico would adjust its estate tax system to reflect the new status of Puerto Rico as a State.

Business operations

In the case of corporations, the Internal Revenue Code also imposes lower statutory rates of income tax than does the Puerto Rican tax system. However, the widespread availability of tax incentives under the Puerto Rican tax system implies that many business enterprises may have greater tax liability under the Internal Revenue Code than under the Puerto Rican system. The increase arising from imposition of Federal tax would be most dramatic for those enterprises eligible for Industrial Zone and other exemptions from Puerto Rican tax. The introduction of the Federal tax system therefore may reduce the variation in tax burdens among different business enterprises but greatly increase the tax burden for corporations most able to use current Puerto Rican exemptions and deductions. Some have suggested that the increased tax burden may discourage future economic development; others believe that a more even distribution of tax among businesses could lead to a more efficient allocation of capital and labor.

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[38] Median family income in Puerto Rico is calculated to be \$5,923 in 1979. This compares to \$14,591 in Mississippi (the lowest level of any present State) and a national average of \$19,917. Memorandum to Senator Moynihan, "Effects of the Proposal For A Referendum on the Status of Puerto Rico," Congressional Research Service, August 1, 1989, at p. 5.

Unlike the U.S. tax system, Puerto Rico does not treat partnerships as nontaxable pass-through entities, except for "special partnerships." The imposition of the U.S. tax system could significantly influence the choice of business entity utilized, encouraging in some cases use of partnerships in Puerto Rico.

2. Code Section 936

Phaseout of credit

Section 213(d) of the bill provides a special transition rule for Code section 936. Under this rule, the credit previously allowed under section 936 with respect to income or investments from activity in Puerto Rico would be reduced to the following percentages:

Taxable years beginning in:	*Percent*
1994	80
1995	60
1996	40
1997	20
1998 and thereafter	0

Under the bill, a qualified possessions corporation that only earns income attributable to Puerto Rican activities in 1991, 1992, and 1993 will pay no U.S. income tax on that income. In 1994, the same company would receive only 80 percent of the benefit provided under section 936, and therefore would be required to pay U.S. tax equal to 20 percent of its pre-credit tax liability. This phaseout of section 936 benefits would continue ratably until 1998, when the company would pay full U.S. income tax on its income from Puerto Rican operations.

Legal issues

Section 213(d) of the bill provides that in implementing the section 936 credit phaseout, Congress would explicitly retain the right to enact appropriate transitional rules, and the Secretary of the Treasury would be authorized to promulgate such regulations as would be necessary. Apart from the currently unspecified transition rules contemplated by the bill, statutory phaseout of the section 936 credit in the bill raises, by itself, certain questions.

For example, under present law only U.S. corporations are affected by the section 936 credit. The credit is not relevant to foreign corporations, including those organized under the laws of Puerto Rico, because they generally incur no U.S. tax liability from the pursuit of solely Puerto Rican activities. Under the bill, as of January 1, 1994, companies that were incorporated under Puerto Rican law will be considered U.S. domestic corporations for U.S. tax purposes, absent an additional change in law. It might be argued that under the language of the bill, such Puerto Rican companies would then be able to elect the use of section 936 assuming they satisfy the other qualification requirements contained in that section. Thus, a Puerto Rican corporation that earns all of its income from Puerto Rican sources would avoid paying any U.S. income tax prior to 1994, and with the use of the section 936 credit, receive partial U.S. tax relief from 1994 through 1997. (It is unclear whether this result represents the intent of the Committee on Energy and Natural Resources.)

It may be necessary to consider whether the grant of a transitional phaseout of section 936 by the bill should serve only to phase in gradually U.S. tax liabilities for those companies that previously received benefits under that section, or should also serve to gradually phase in U.S. tax liabilities for most Puerto Rican corporations that had previously not benefited from section 936. No such gradual phasein applies to Puerto Rican individuals. Depending on tax rates faced by a Puerto Rican corporation, such a broad phasein simply may provide a temporary reduction in income tax liabilities. This potential benefit may be unrelated to the transitional concerns expressed by the Committee on Energy and Natural Resources.

Another issue involves the determination of the source of income earned by a qualified possessions corporation. Section 936(a)(1)(A) provides for a credit against U.S. tax on foreign source income only. Upon Puerto Rico's admittance as a State, income earned from sources within Puerto Rico would generally be treated as U.S. source income for all purposes of the Internal Revenue Code. Thus, U.S. tax on such income technically would not be eligible to be offset by the section 936 credit. This treatment would virtually eliminate all benefit of the section 936 credit to qualified possessions corporations over the transitional period unless their income was of such a nature as to be susceptible to resourcing to a foreign country or possession. If the transitional rule currently in the bill, or any similar phaseout of section 936 is adopted, the treatment of Puerto Rican source income for this purpose may need to be clarified.

A third issue involves the treatment of Puerto Rican taxes. Section 936(c) provides that any tax imposed by a foreign country or possession of the United States with respect to income of a qualified possessions corporation that is taken into account in computing the section 936 credit shall not be treated as a tax that is either creditable under the foreign tax credit rules or deductible by such corporation. This rule operates to deny a qualified possessions corporation a double benefit since the section 936 credit operates to spare the corporation any U.S. income tax on its possession source income. Beginning in 1994, income taxes paid to Puerto Rico will no longer be considered taxes paid to a foreign country or a possession of the United States. Rather, they will be taxes paid to a State, which are generally deductible for U.S. tax purposes. As a result, based on the technical language of section 936(c), the disallowance of a deduction for income taxes related to income which is eligible for the section 936 credit would not apply to taxes paid to Puerto Rico. During the transition period, this inapplicability might permit both a deduction and a credit under section 936 for the same tax, unless amendments were made.

The interplay of the deduction of Puerto Rican taxes and the phaseout of section 936 is illustrated by the following example. Assume that in 1994 a qualified possessions corporation earns $100 of income solely from its operations in Puerto Rico, and pays $20 of income tax to Puerto Rico. If Puerto Rican taxes are treated as nondeductible under section 936(c), the company would have a pre-section 936 credit U.S. tax liability of $34. Under present law, the section 936 credit would offset the company's entire U.S. tax liability. However, pursuant to the phaseout of section 936, the company is allowed a benefit equal to only 80 percent of the credit allowed under present law. Thus, under one reading of the bill, the company's net tax liability for 1994 would be $6.80.[39] If, on the other hand, the taxpayer were allowed to deduct Puerto Rican tax, its pre-credit U.S. tax liability would be $27.20, 80 percent of which is $21.76. Therefore, under the bill a taxpayer might plausibly take the position that it is entitled to a section 936 credit in 1994 of $21.76 against a pre-credit tax liability of $27.20, resulting in a net U.S. tax liability of $5.44. The difference between $6.80 and $5.44 (i.e., $1.36) represents U.S. tax on the portion of Puerto Rican taxes paid by the company corresponding to the portion of its income not eligible for the 936 credit.[40]

It would appear proper to allow a deduction for those taxes paid to the new State of Puerto Rico attributable to the portion of income that is not granted section 936 benefits during the phaseout period, since no double benefit is available to the qualified possessions corporation with respect to such taxes. Under this view, the correct amount of net U.S. tax in the above example would be $5.44. Taxes paid to a foreign country or U.S. possession attributable to income not eligible for the section 936 credit pursuant to the transition rules could properly be regarded as creditable, assuming the requirements for the foreign tax credit were otherwise met.

Economic issues

Background.—The gross domestic product of Puerto Rico grew at an average rate of 5.2 percent per year between 1950 and 1979. Manufacturing had been the dominant source of growth in Puerto Rican development in the post-World War II era, as manufacturing employment grew from 9 to 20 percent of total employment during the same period. Since 1980, however, real growth has declined to rates similar to U.S. rates, with gross domestic product growing 1 percent between 1979 and 1983, and 4 percent between 1983 and 1988. The proportion of manufacturing jobs has declined from 20 percent to 18 percent of employment during the past eight years.

Section 936 may have played a significant role in the economic development of Puerto Rico. It is estimated that there were 88,579 employees in 527 qualified possessions corporations that were engaged in manufacturing in 1983.[41] In 1988, there were approximately 157,000 manufacturing jobs and a total of over 870,000 jobs in Puerto Rico. Section 936 companies may account for around half of manufacturing employment in Puerto Rico, but only about a tenth of total employment. Because the measured value-added per employee is higher in the manufacturing sector than in other sectors (and even higher in section 936 companies), qualified possessions corporations account for a relatively greater percentage of gross domestic product than of employment.

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[39] $34.00 x (1 - .80) = $6.80

[40] $20.00 x .20 x .34 = $1.36.

[41] *The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report*, Department of the Treasury, March, 1989 (Sixth Possessions Report).

Some argue that the effect of section 936 companies on Puerto Rican employment goes beyond the direct employment by section 936 companies. Employment is stimulated, it is argued, in sectors of the economy which purchase output of or supply goods to qualified possessions corporations. In addition, as qualified possessions corporations' employees' wages may exceed the income they would otherwise earn, employment is increased by the consumption spending of these employees. Some estimates claim that between one and three additional jobs are created for each employee of a qualified possessions corporation.[42]

The Treasury Department and others argue that the indirect effect of section 936 on Puerto Rican employment is weak, and that estimates showing large effects are flawed on both theoretical and technical grounds.[43] In addition, they contend that looking at the number of workers employed by section 936 companies overstates the effect of section 936 on employment. They maintain that many of these employees would, in the absence of section 936, be otherwise employed, although perhaps at lower rates of pay.

The efficiency of section 936 as an incentive for economic development is in dispute. Proponents assert that section 936 is crucial for attracting capital-intensive manufacturing companies, particularly in chemicals and electronics, which have spurred Puerto Rican development and led to major increases in employment and wages.

Opponents argue that the effect on employment is limited and the costs far exceed the benefits. The Treasury Department estimated that the tax benefits of section 936 were $18,523 per qualified possessions corporation employee in 1983, which equalled 125 percent of employee compensation. The changes made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) helped lower the ratio of tax benefits to employee compensation from 148 percent of employee compensation in 1982 and further reductions may occur in the future because of post-1982 changes in section 936.[44] Efficiency considerations led the Reagan Administration to propose replacing section 936 with a wage credit in 1985.[45]

Elimination of section 936.– The effect of eliminating section 936 on the Puerto Rican economy depends on the reaction of qualified possessions corporations and the significance of these companies to the Puerto Rican economy. The phaseout of section 936 benefits would expose qualified possessions corporations to levels of taxation to which they previously had not been subject. Certain companies that have made substantial investments in manufacturing operations in Puerto Rico, both in terms of physical plant and in the development of a reliable and skilled workforce, may conclude it would be most efficient to maintain their operations in Puerto Rico. Indeed, some level of direct U.S. investment in Puerto Rico may continue regardless of the availability of section 936 benefits.

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[42] Such estimates are discussed in *Sixth Possessions Report*, at 55.

[43] *Sixth Possessions Report*.

[44] *Sixth Possessions Report*.

[45] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*. May 1985. *See also, Tax Reform for Fairness, Simplicity, and Economic Growth, Vol. 2*, Department of the Treasury, November 1984.

Other companies that located in Puerto Rico primarily because of the U.S. tax benefits may conclude that the after-tax return is no longer adequate to maintain operations in Puerto Rico. These operations may be eliminated, moved to the United States, or replaced by operations conducted through a foreign subsidiary in a foreign country where generous tax holidays or other incentive programs may be available. In addition, the decision to locate future operations in Puerto Rico will be adversely affected, all else the same, by the loss of section 936 benefits.

The effect of any reduced U.S. investment in Puerto Rico through qualified possessions corporations is uncertain. The dispute regarding the direct and indirect employment effects of section 936 is echoed in the analysis of the effect of the phaseout on the Puerto Rican economy. To the extent both the direct and indirect effects are small, the elimination of section 936 benefits may have a limited impact on Puerto Rican employment and wages. However, given the relatively high unemployment levels in Puerto Rico, the ability for the economy to absorb workers displaced from qualified possessions corporations may be limited, and increased unemployment may result.

Qualified possession source investment income.—A substantial amount of retained earnings from Puerto Rican operations of qualified possessions corporations has been invested in certain Puerto Rican financial institutions in order to generate QPSII. Once the tax incentive for qualified possessions corporations to reinvest those amounts in Puerto Rico is removed, it is possible that those funds will be repatriated to U.S. parent companies or used elsewhere. The phaseout of section 936 will reduce the subsidy that has been available to certain Puerto Rican financial institutions through the lower interest rates required on QPSII funds. The cost of funds may increase and the amount of financial capital available to Puerto Rican financial institutions may be reduced. The effect on the ability of Puerto Rican business to raise funds would depend, however, on the extent that existing QPSII funds actually expand the pool of funds available to Puerto Rican enterprises rather than being invested elsewhere or displacing other funds available to Puerto Rican businesses.

3. Excise taxes and customs duties

Notwithstanding the general delay of Internal Revenue Code applicability to Puerto Rico until 1994, the bill specifically provides that, effective on the date of admission to statehood, all Federal excise taxes are applicable to Puerto Rico in the same manner as they apply to other States (bill sec. 213(a)). However, the bill further provides that all revenues derived from excise taxes made applicable to Puerto Rico by the bill, as well as the current payment provided by permanent indefinite appropriations of customs duties and equivalency excise tax payments on alcohol, are generally to be covered over to Puerto Rico as a statehood grant until Congress passes a law providing otherwise (but not before October 2, 1998). Thus, unlike other States, the Puerto Rican State Treasury would receive the receipts from the Federal excise taxes instead of the Federal Government. As under current law, however, excise taxes would not be covered to Puerto Rico with respect to any article (other than an article containing distilled spirits) if Puerto Rico provides a direct or indirect subsidy with respect to the article unlike subsidies offered to industries producing articles not subject to Federal excise taxes.

The application of Federal excise taxes in addition to existing Puerto Rican excise taxes (see the Appendices) could result in increases in the prices of certain articles. Puerto Rico might adjust its excise taxes, however, in response to the imposition of Federal tax. Under the bill, Puerto Rico would be in the unique position where revenue from Federal excise taxes made applicable in the State of Puerto Rico would be transferred to the State government.[46] In effect, the Federal excise tax could be viewed as a State tax, except that the rates would be set and collection performed by the U.S. government.

4. Uniformity clause

The U.S. Constitution grants to the Congress the power to lay and collect "Taxes, Duties, Imposts and Excises, . . . but all Duties, Imposts and Excises shall be uniform throughout the United States." U.S. Const., art. I, sec. 8, cl. 1.[47] As indicated by the absence of the word "taxes" from the clause setting forth the rule of uniformity (the "uniformity clause"), the rule applies only to the subset of taxes encompassed by the terms "duties, imposts and excises." In addition, it is clear from other parts of article I that the uniformity clause does not apply to the subset of taxes denoted in the Constitution as "direct" taxes, which are subject to "apportionment" requirements rather than "uniformity" (*see* sec. 2, cl. 3; sec. 9, cl. 4).

Thus, insofar as the bill provides for special treatment of Puerto Rico as to any particular "duties, imposts [or] excises" once Puerto Rico becomes a State, it may be appropriate to examine whether the application of such a tax under the bill is or is not "uniform."

Duty, impost or excise

As described above, the bill's application of Federal income taxation to a new State of Puerto Rico differs in at least two respects, during a period beginning on or after October 1, 1991, and ending during 1998, from the application of such taxation to the existing States.[48] First, the Federal income tax would not be applied to the new State of Puerto Rico until January 1, 1994 Second, the income tax credit provided by section 936 of the Code would be phased out over a period that would end during 1998, rather than terminated immediately upon statehood. Thus, the preliminary issue in any uniformity clause analysis of the provisions of the bill is whether the Federal income tax constitutes a duty, impost or excise, as such terms are used in the uniformity clause.

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[46] As noted above, section 208(a) of the bill provides that, unless a different treatment is expressly provided, all U.S. laws shall have the same force and effect within the State of Puerto Rico as they did within the Commonwealth of Puerto Rico immediately prior to the date of admission to statehood. The bill is somewhat unclear whether the provisions of current law section 7652 that provide for cover over to Puerto Rico of excise tax revenues would be repealed effective prior to 1994 because they are inconsistent with section 213 of the bill, in which case, after Puerto Rico becomes a State, only those revenues from excise taxes "which became applicable in" Puerto Rico pursuant to the bill would be covered over to the Puerto Rican Treasury (at least through October 1, 1998).

[47] Note that there is no comparable limitation on the spending power of Congress. *See, e.g.*, *Helvering v. Davis*, 301 U.S. 619 (1937) (Congress has discretion to determine that the general welfare is served by an expenditure program that addresses local problems).

Some believe that the Federal income tax does constitute such a duty, impost or excise, although judicial pronouncements on this issue have not followed a consistent path. For example, the Supreme Court in *Pollock v. Farmers' Trust and Loan Co.*, 157 U.S. 429 (1895), considered the classification of a tax on income from real property by reference to the source of the income, and characterized such a tax as equivalent to a tax on real property. The Court thus distinguished authorities that treated a tax imposed on interest and professional income as a duty, impost or excise, and classified the tax on income from property as a direct tax subject to the apportionment requirement. However, the Supreme Court subsequently held in *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911), that a tax on corporations measured by income was not a direct tax but an excise on the privilege of doing business in the corporate form, and thus subject to the requirement of uniformity rather than apportionment.

In 1913, the sixteenth amendment exempted income taxes from the apportionment clauses and thereby mooted the primary significance of the classification of a tax as direct or not. However, the Supreme Court in *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916), rejected an interpretation of the sixteenth amendment that would view the Federal income tax as a direct tax that is exempt from the apportionment requirement. Under such an interpretation, the income tax would be arguably exempt (as a direct tax) also from the uniformity requirement. Instead, the Court interpreted the sixteenth amendment to prevent the classification of an income tax by reference to the source of the income, which could "take an income tax out of the class of excises, duties, and imposts and place it in the class of direct taxes." *Id.* at 19. Therefore, despite the fact that some aspects of an income tax have been classified as direct, it may be fairly argued that the Federal income tax as a whole is subject to the requirements of the uniformity clause.

Uniformity

According to Justice Story, the purpose of the uniformity clause

> was to cut off all undue preferences of one State over another in the regulation of subjects affecting their common interests. Unless duties, imposts, and excises were uniform, the grossest and most oppressive inequalities, vitally affecting the pursuits and employments of the people of

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[48] As discussed above, there would be no differences between Puerto Rico and the pre-existing States in the imposition of excise taxes (as distinguished from the expenditure of excise tax collections).

> different States, might exist. The agriculture, commerce, or manufactures of one State might be built up on the ruins of those of another; and a combination of a few States in Congress might secure a monopoly of certain branches of trade and business to themselves, to the injury, if not to the destruction, of their less favored neighbors.[49]

Other experts, scholars and judges have concurred.[50]

The uniformity clause does not require that all affected taxes fall equally or proportionately on each State or region. The clause requires only that a tax operate "with the same force and effect in every place where the subject of it is found." *Head Money Cases*, 112 U.S. 580, 594 (1884) (upholding as uniform a tax on immigrants through seaports but not on immigrants through inland cities). Thus, there is no prohibited geographic discrimination merely because the subject of a tax is distributed disproportionately across the country. Similarly, in the case of the uniformity requirement of the bankruptcy clause (U.S. Const., art. I, sec. 8, cl. 4), "[t]he uniformity provision does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 159 (1974).

Most recently, the Supreme Court held that an exception for certain Alaskan crude oil from the Crude Oil Windfall Profit Tax Act of 1980 did not violate the tax uniformity clause. *United States v. Ptasynski*, 462 U.S. 74 (1983). That Act was "designed to impose relatively high tax rates where production cannot be expected to respond very much to further increases in price and relatively low tax rates on oil whose production is likely to be responsive to price." H.R. Rep. No. 96-304, 96th Cong., 2d Sess. 7 (1980), cited in *Ptasynski*, at 77. To that end, Congress exempted certain classes of oil from the tax, including a relatively limited subset of the oil produced in Alaska, denoted "exempt Alaskan oil." Exempt Alaskan oil was defined geographically, by reference to the Arctic Circle and the Alaska-Aleutian Range.

The exemption reflected the considered judgment of Congress that unique climatic and geographic conditions required that oil produced from a specified area be treated as a separate class of oil. H.R. Rep. No. 96-817, 96th Cong., 2d Sess. 103 (1980). The Supreme Court found that Congress had before it ample evidence of the disproportionate costs and difficulties associated with extracting oil from this region. The Court stated that it could not fault the determination of Congress, based on neutral factors, that this oil required separate treatment. 462 U.S. at 85. Nor was there any evidence that Congress sought to benefit Alaska for reasons that would offend the purposes of the uniformity clause (for example, by intending to grant Alaska an undue preference at the expense of other oil-producing States), especially in view of the fact that the tax generally fell heavily on Alaskan oil. *Id.* at 77-78 (n.5). Accordingly, the exemption was held not to violate the uniformity clause.

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[49] 1 J. Story, *Commentaries on the Constitution of the United States* sec. 957 (T. Cooley ed. 1873), cited in *United States v. Ptasynski*, 462 U.S. 74, 81 (1983).

[50] See 2 M. Farrand, *The Records of the Federal Convention of 1787*, pp. 417-418 (1911). See also 3 *Annals of Cong.* 378-379 (1792) (remarks of Hugh Williamson); Address of Luther Martin to the Maryland Legislature (Nov. 29, 1787), reprinted in 3 M. Farrand, *supra*, at 205 (all cited in *Ptasynski*, at 81-82).

The Supreme Court in *Ptasynski*, following the analysis of the *Regional Rail Reorganization Act Cases* decision, opined that the uniformity clause gives Congress wide latitude in deciding what to tax, and does not prevent Congress from considering geographically isolated problems. If Congress defines the subject of the tax in nongeographic terms, the uniformity clause is satisfied. *Id.* at 84. Identifying the subject of a tax in terms of its geographic boundaries does not render the tax invalid, but rather triggers a close examination of the classification to see if there is prohibited discrimination in light of the purposes of the uniformity clause. *Id.* at 85.

Some have argued that the exemption of the new State of Puerto Rico from the entire scheme of Federal income taxation cannot be justified in a manner that would be consistent with the uniformity clause as it has been interpreted under existing case law. They distinguish *Ptasynski* on several grounds, including the fact that the preferred tax status of Puerto Rico under the bill is not offset by substantial Federal tax burdens on Puerto Rico; in *Ptasynski*, by contrast, Alaska overall bore a large share of windfall profits tax burdens while only a small subset of Alaskan oil was exempt. Thus, it is argued that the proposed delay in applying Federal income taxation to the State of Puerto Rico would violate the uniformity clause. In addition, it has been argued that section 936, which is intended to promote the economic development of U.S. possessions, provides to Puerto Rico precisely the kind of preference that the uniformity clause prevents among States.

It has been further argued that the temporary nature of the differences in tax treatment provided to Puerto Rico under the statehood option of the bill would not make such differences any less offensive to the uniformity clause of the Constitution. There is apparently no authority under the uniformity clause that directly considers whether a temporary nonuniformity would violate the clause. However, the Supreme Court did invalidate a transition provision in the enabling act under which Oklahoma was admitted as a State, which provision would have prevented Oklahoma from moving its State capital from Guthrie to Oklahoma City for a period of six and one-half years after Oklahoma's admission as a State. In *Coyle v. Smith*, 221 U.S. 559 (1911), the Court ruled that Congress is not authorized, by the power to admit new States (U.S. Const., art. IV, sec. 3) or otherwise, to impose a term or condition on the admission of a new State that would render the new State "less or greater, or different in dignity or power," from the pre-existing States. *Id.* at 566. The Court held that Congress did not have the power to include an otherwise unconstitutional provision in the Act under which Oklahoma was admitted to the Union, even though the provision was temporary.

Others argue, however, that special tax treatment of Puerto Rico, whether temporary or permanent, would not violate the uniformity clause. In fact, the Committee on Energy and Natural Resources has taken the latter view with respect to temporary differences, stating that it

> believes Congress has substantial authority under the territorial and statehood clauses of the Constitution to provide for non-identical economic treatment under statehood if such treatment is reasonable, transitional, and necessary. The provisions of Section 213 [of the bill] are not only reasonable, but necessary in order to provide: Federal agencies the time needed to implement certain new taxes and social programs in Puerto Rico, Puerto Rico with the time needed to modify local tax and social program laws, and to avoid extremely serious disruptions to the economy of Puerto Rico during the transition from commonwealth status to statehood.[51]

It may be argued that the uniformity clause raises serious concerns as to the validity of the tax provisions provided under the statehood option of the bill. All other things being equal, some might view it as preferable, from a constitutional view, for Congress to address the general administrative problems of transition by providing a sufficient delay between the status referendum in 1991 and the date of actual admission of Puerto Rico as a State, rather than by delaying the application of Federal income taxation to Puerto Rico for any period after admission. On the other hand, there are bases on which to distinguish the authorities relied on by some for the proposition that the bill is unconstitutional. The committee may consider whether or not such distinctions are material.

The intent and purpose of the uniformity clause, as explained by Justice Story, may have been to prevent a combination of States from setting differential tax provisions that would harm the economic interests of another State or States. Even in *Coyle v. Smith*, the temporary measure that was invalidated was an attempt by the existing States to deny the new State of Oklahoma a state power protected by the Constitution—namely, the power to locate its state capital. The seven-year phaseout of section 936, in contrast, would be a temporary benefit granted to Puerto Rico by the current States intended to ease the economic integration of a new State. Similarly, the two-year delay in imposing Federal taxation generally in Puerto Rico would be a temporary benefit granted to Puerto Rico by the current States that would ease the administrative burdens of moving to full statehood treatment under the Internal Revenue Code. Some would argue that the concerns addressed by the uniformity clause may not be implicated as severely where the only differential taxation applies in a reasonable transition period between present law and full uniformity.

In addition, the Supreme Court in *Ptasynski* was "reluctant to disturb [Congress's] determination" by finding a violation of the uniformity clause where Congress "has exercised its considered judgment with respect to an enormously complex problem." 462 U.S. at 86. Accordingly, it may be argued that a set of transitional provisions for the admission of a State, such as the one crafted by the Committee on Energy and Natural Resources to address actual problems that are unique to Puerto Rico, satisfies the requirements of the uniformity clause. If the Committee on Finance chooses to adopt transition provisions at all similar to those reported out by the Committee on Energy and Natural Resources, then to the extent the Finance Committee can further articulate the specific rationale for such provisions, it may thereby strengthen the argument that the uniformity clause is satisfied.

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[51] S. Rep. No. 101-120, at 39.

C. Independence Provisions

1. Citizenship

Under the bill, if independent status is chosen by the Puerto Rican voters, Puerto Rico would no longer be deemed to be part of the United States for the purpose of acquiring U.S. citizenship by reason of place of birth after the date of certification of the referendum. In addition, no person born outside of the United States after the proclamation of independence would be granted U.S. citizenship at birth as a result of being born to parents who acquired U.S. citizenship solely by virtue of being born in Puerto Rico prior to the proclamation of independence. The U.S. citizenship status of persons born in Puerto Rico prior to certification of the referendum would remain unchanged.

The bill does not address the U.S. citizenship status of persons born in Puerto Rico, or born to Puerto Rican-born parents, after certification of the referendum but before the proclamation of independence. Because the interval between those two events is uncertain under the bill, and because status as a U.S. citizen has U.S. tax consequences, the committee may choose to consider what the citizenship consequences of birth in that interval would be, and whether it would be desirable (as a matter of certainty of tax administration or otherwise) to conform the dates applicable to citizenship determinations under the bill so that they are all based either on the date of certification or the date of proclamation of independence.

The bill also does not expressly address the effect that Puerto Rican independence would have on the existing Code provision that exempts Puerto Rican residents who are U.S. citizens from the U.S. tax otherwise imposed on a U.S. citizen's worldwide income (Code sec. 933). There may be little policy reason to retain a complete and unlimited exclusion from taxable income for income earned from Puerto Rican sources by U.S. citizens who reside in Puerto Rico.[52] Those individuals could be eligible, however, to claim the benefits of either the foreign earned income exclusion (sec. 911) or the foreign tax credit (sec. 901) with respect to certain income earned outside of the United States.

In some cases, however, it may be argued that the logic of a section 933 exception will continue to apply. Absent section 933, Puerto Rican resident individuals who retain U.S. citizenship subsequent to the proclamation of independence may be faced with U.S. income tax return filing responsibilities for the first time. As previously discussed, a U.S. citizen is relieved from the requirement of filing a tax return if his gross income for the taxable year is less than the sum of the amount of the personal exemption and the amount of the applicable standard deduction. Although section 911 excludes (up to $70,000) the foreign earned income of a U.S. citizen from gross income, the benefits of section 911 must be expressly elected by such person on his U.S. individual income tax return for the taxable year. Alternatively, the foreign tax credit rules do not exclude foreign source income from gross income. Rather, they provide a tax credit against the taxpayer's U.S. tax liability, subject to certain limitations, for foreign taxes paid with respect to such income. In cases where foreign taxes on a particular taxpayer's income are not as high as U.S. taxes, the credit still leaves a residual U.S. tax liability. Thus, U.S. citizens resident in Puerto Rico who have heretofore avoided filing U.S. income tax returns as a result of the application of section 933, may be required to pay U.S. tax or to file U.S. tax returns for future taxable years, depending upon the resolution of the issue regarding the future application of section 933.

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[52] Similar tax treatment afforded to U.S. corporations with operations in Puerto Rico under section 936 is expressly eliminated under the bill. The bill states generally that all U.S. laws applicable to the Commonwealth of Puerto Rico immediately prior to the proclamation of independence shall no longer apply in the Republic of Puerto Rico (bill sec. 308(a)(2)). Some might argue that the specific repeal of section 936 with respect to Puerto Rico (bill sec. 317(a)) suggests that the Committee on Energy and Natural Resources intended bill section 308(a)(2) to have no effect on the application of U.S. law to the U.S. tax obligations of individuals or corporations. Alternatively, it might be argued that section 933 is a U.S. law applicable to the Commonwealth of Puerto Rico and as such that it is repealed in under bill section 308(a)(2).

After Pureto Rican independence, U.S. citizens resident in Puerto Rico would not be treated as residents of a possession for purposes of the relief from estate and gift taxation provided under sections 2209 and 2501(a) of the Code (discussed above in Part I.A.1). Accordingly, effective for decedents dying and gifts made after the effective date of Puerto Rican independence, all U.S. citizens resident in Puerto Rico would be subject to worldwide U.S. estate and gift taxation on the same basis as U.S. citizens resident in any other foreign country. However, individuals born after independence who do not become citizens or residents of the United States would not be subject to Federal estate or gift taxation.

2. Code section 936

Immediate elimination

Under section 317(a) of the bill, effective on the date of proclamation of independence by Puerto Rico, the section 936 credit would not be allowed with respect to income or investments from Puerto Rican activity. Thus, as of such date, all taxable income earned by qualified possessions corporations from the active conduct of a trade or business in Puerto Rico and the QPSII related to the investment of section 936 profits in Puerto Rico would be subject to U.S. tax.

The effects of eliminating the use of section 936 for U.S.-owned business operations may not be as severe as might appear at first glance. The income attributable to the conduct of an active trade or business in a foreign country by a foreign corporation owned by U.S. persons is generally not subject to current U.S. taxation. Such income of the foreign corporation generally is taxable only when repatriated to the U.S. owner. If there is sufficient U.S. ownership of the corporation, as is typically true of existing qualified possessions corporations, an indirect credit for foreign taxes paid on the corporation's income is available, with limitations.

Thus, if a U.S. person uses a foreign corporation (e.g., one organized under Puerto Rican law) instead of a U.S. corporation to do business in Puerto Rico, the effective burden of U.S. tax on active business income in Puerto Rico may be small due to the benefits of deferral. It is often pointed out that the effective burden of a tax deferred for a sufficiently long period of time approaches that of exemption. It is also possible that excess foreign tax credits available from other sources may be applied against the U.S. tax on income from Puerto Rico.

Some argue, however, that the effects of the elimination of section 936 may not be easily mitigated. Reorganizing existing qualified possessions corporations as foreign corporations may not always be practicable. Also, the imposition of U.S. tax upon a distribution to the U.S. owner imposes a tax burden, even though deferred, that may not currently exist. Lastly, investment income may be subject to immediate U.S. tax, with a foreign tax credit, and may not be eligible for deferral.

Tax-sparing implications if retained

As originally introduced, the bill contained a provision that would have continued the application of section 936 with respect to Puerto Rico under the independence option. This provision was deleted by the Committee on Energy and Natural Resources. By doing so, the committee made the bill more consistent with general U.S. international tax policy. As a general principle, the United States taxes domestic corporations on their worldwide income. However, section 901 prevents the double taxation of certain foreign source income with respect to which the taxpayer has paid or accrued foreign tax by allowing a credit for such tax up to the amount of the U.S. tax attributable to such income. Generally, foreign countries provide similar treatment either by allowing a foreign tax credit or by only subjecting to tax income earned from sources within the taxing jurisdiction. The section 936 credit operates differently than the foreign tax credit in that the allowance of a credit is not dependent upon the existence of a foreign tax liability of the taxpayer. Thus, the section 936 credit is considered a tax-sparing credit.

Section 936 has operated in the past as a mechanism to encourage investment by domestic corporations in U.S. possessions in order to assist in the development of the economies of those possessions. As some possessions may assess little or no tax on U.S. companies that establish operations within their borders, such operations have in many cases produced tax-free income to qualified possessions corporations. The U.S. does not provide a tax-sparing credit to companies that operate in independent foreign countries, and has resisted all efforts by capital-importing countries to include tax-sparing credits in tax-treaty relationships with the United States.

If Puerto Rico becomes an independent country, it would be inconsistent with U.S. tax treaty policy for the United States to continue to allow a tax-sparing credit to companies with operations in Puerto Rico. To do so would discriminate against U.S. companies with operations in other foreign countries. However, any income tax paid to Puerto Rico with respect to income from Puerto Rican sources should generally qualify as a foreign income tax that is eligible for the foreign tax credit, thereby granting companies with Puerto Rican operations the same treatment as afforded to other companies with multinational operations. As previously discussed, most qualified possessions corporations are currently benefitting from full or partial tax exemptions from Puerto Rican tax. Whether or not those exemptions would continue subsequent to the proclamation of independence would be a decision to be made independently by the Puerto Rican government.

3. Excise taxes

The bill does not contain a specific provision governing excise taxes in the event that Puerto Rico should become an independent republic. However, section 308 of the bill provides a general rule that (except as otherwise provided) upon a proclamation of independence, all laws of the United States applicable to Puerto Rico immediately prior to independence would no longer apply. This apparently would result in repeal of present-law sections 7652 and 7653 of the Internal Revenue Code. Thus, upon a proclamation of independence, articles manufactured in Puerto Rico and shipped to the United States (and *vice versa*) would be treated as articles shipped from (and to) a foreign country for excise tax purposes, and Federal excise tax revenues (including rum excise taxes) would no longer be covered over to the Puerto Rican Treasury pursuant to section 7652 but instead would be retained by the U.S. Treasury.

4. Tax treaty negotiation and ratification

Section 317(b) of the bill provides for the establishment of a Task Force on Taxation to negotiate appropriate tax treaties to govern relations between the United States and Puerto Rico. Under the bill, any agreements so negotiated must be approved by the government of Puerto Rico and the United States in accordance with their respective constitutional processes. In the case of the United States, entry into a treaty requires transmittal of the treaty by the President to the Senate, consent by two-thirds vote of the Senate, and ratification of the Senate-approved treaty by the President.

From the standpoint of the United States, the bill could potentially alter the normal course of treaty negotiations. The bill appears to give the Joint Transition Commission, rather than the President, the ability to appoint the negotiators representing the United States. By contrast, U.S. tax treaties are ordinarily negotiated for the United States by officials of the Office of Tax Policy within the Treasury Department, who have broad areas of responsibility in the formation of U.S. statutory and treaty tax policy. The Committee on Finance may wish to consider whether the bill should take the job of negotiating U.S.-Puerto Rico tax treaties away from the office that may be most sensitive to the favorable or unfavorable precedential effect of a Puerto Rican treaty by changing the ordinary method for designating the individuals who would negotiate the treaty.

Given the bill's apparent requirement that ordinary constitutional procedures for the approval of any U.S.-Puerto Rico tax treaty, once negotiated, be followed, it should be possible under the bill to prevent the entry into a treaty containing what the U.S. government views as an inappropriate treaty policy for dealing with Puerto Rico. The treaty negotiated would presumably be subject to Senate advice and consent, and Presidential ratification, as is true for any other treaty. Any concerns that the Senate and the Executive Branch might have about provisions that are inappropriate for a U.S.-Puerto Rico treaty would therefore have opportunity for expression prior to any such treaty entering into force. It may be argued, however, that the process of obtaining a treaty that can pass the Senate and be ratified would be more efficient if the negotiators were chosen by one or both of those branches directly, rather than indirectly through the Joint Transition Commission. The Committee on Finance may wish to clarify the procedure under which any treaty would be negotiated and to express its views as to which types of treaty provisions it views as appropriate or not (e.g., tax-sparing).

5. Tax-exempt bonds

The bill provides that if the interest on bonds issued by Puerto Rico currently is exempt from tax in the United States, the interest on those bonds would continue to be exempt from tax when held by a United States taxpayer after Puerto Rico's proclamation of independence. The bill does not affect the treatment of any bonds issued by Puerto Rico after its proclamation of independence. Thus, such bonds would be treated similarly to the indebtedness of any other foreign country when held by a taxpayer in the United States; that is, the interest on such bonds would be subject to tax.

When U.S. taxpayers purchase the bonds of corporations, foreign governments, and the Federal Government itself they recognize that they are liable for tax on the interest paid by those bonds. Because purchasers of bonds generally seek the highest net return consistent with their preferences for risk, tax exemption enables State and local governments, including Puerto Rico, to sell bonds to United States taxpayers at interest rates which generally are lower than those offered by corporations, foreign governments, and the Federal Government. Because a bond's coupon rate generally is fixed at the time of its sale, revocation of tax exemption for bonds which were initially issued as tax-exempt bonds would create substantial reductions in the market value of the bonds, and potentially create substantial capital losses for the bondholders, unless specific covenants provide otherwise.

For example, assume a taxpayer holds a bond whose interest is tax-exempt, which pays a coupon rate of $10 per year, and will repay the bondholder $100 in 10 years. Assume the discount rate is 10 percent. This bond would be worth $100 (the present value of the annual coupon payments plus the payment of $100 in the tenth year). If the tax exemption of this bond were revoked, the bondholder's net after-tax income from the annual coupons might be $7. Now the bond would be worth $81.56 (the present value of the net after-tax coupon payments plus the payment of $100 in the tenth year). This represents nearly a 20-percent reduction in the value of the bond. Retaining tax exemption for outstanding tax-exempt bonds might forestall the creation of potential windfall losses in connection with tax-exempt bonds of Puerto Rico for which tax exemption is revoked.

The interest saving which accrues to Puerto Rico under present law is the result of the Federal Government foregoing the collection of tax on the interest paid by Puerto Rico to its bondholders. As such, tax exemption creates a subsidy from the Federal Government to Puerto Rico on its interest costs. After independence, the tax subsidy for interest on newly issued bonds would no longer be provided. Puerto Rico would have to compete with corporations, the Federal Government, and other foreign governments when selling bonds. Consequently, Puerto Rico's future interest costs would be higher than if tax exemption were retained.

6. CBI participation

The bill provides that in the absence of a U.S.-Puerto Rico mutual free trade agreement, Puerto Rico would qualify for designation as a beneficiary country under the CBI, assuming it is not disqualified for any of the reasons that would statutorily disable the President from designating it as a beneficiary country. Thus, under the bill, assuming that the Republic of Puerto Rico also entered into a suitable agreement for the exchange of tax information with the United States, at some future time Puerto Rican companies might be eligible for FSC status by the terms of the bill, and certain Puerto Rico convention expenses would be eligible for deduction. In addition, the non-tax benefits flowing from CBI beneficiary status might also apply to Puerto Rico.

D. Enhanced Commonwealth Provisions

1. Code Section 936

The bill does not address the operation of section 936 as it relates to the enhanced commonwealth status option. It is apparently assumed that section 936, to the extent that it continues to be part of the Code, would continue to apply to Puerto Rico if such option were selected. It is further apparently assumed that any subsequent modifications to section 936 by Congress would be applicable to Puerto Rico.

2. Treaties

The bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interest of Puerto Rico as authorized by the President of the United States consistent with the laws and international obligations of the United States. The committee may wish to consider whether this provision should be modified insofar as it relates to tax treaties.

Some have argued that the fact that Puerto Rico is not generally covered by tax treaties has adversely affected Puerto Rico. The Committee on Finance may wish to consider the issue of whether such treaties or other international agreements would be desirable or not, and if desirable, whether existing law or the bill (to the extent, if any, that the bill changes existing law[53]) should be changed to facilitate entry into such treaties. For example, some may argue that Puerto Rico should have the ability to negotiate treaties with capital exporting nations that would provide for tax sparing, thus giving Puerto Rico an additional source of tax-favored foreign capital in addition to the capital attracted by section 936 of the Code.

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[53] *Cf.* Davidson, "Tax Sparing: A Question of Treasury Policy or Puerto Rico Politics," 35 *Tax Notes* 731, 734 (1987).

However these issues are resolved, it may be appropriate to consider further refinements to the procedure by which any Puerto Rico international agreements would be authorized under the bill. For example, the Constitution provides that treaties may only be entered into with the advice and consent of the Senate. Therefore, if the Federal Government is to give the Commonwealth a right to enter into international obligations affecting taxes consistent with U.S. laws and treaties, the committee may find it desirable that Senate advice and consent be required before the President authorizes the entry into such obligations by the Commonwealth.

3. Application of Federal law

The bill generally provides for repeal of Federal laws insofar as they apply to Puerto Rico, upon a joint resolution of Congress approving a recommendation for such repeal submitted to Congress by the Government of Puerto Rico, and amends both the Senate and House rules that would otherwise be applicable to the process of passing such a joint resolution so as to provide a "fast-track" procedure. Among other things, the Senate rule amendment would curtail unlimited debate that might otherwise be permitted. As compared to current law fast-track procedures that exist, for example, under the Congressional Budget Act and certain other provisions,[54] the bill may be viewed as relatively unique insofar as it extends such procedures to initiatives of the Government of Puerto Rico that seek to override existing legislation. However, the bill does not provide for the application of this rule to any Federal statutory law (1) establishing grants or services to individual U.S. citizens, (2) relating to citizenship, or (3) pertaining to foreign relations, defense, or national security.

Such a procedure for repeal of laws applicable to Puerto Rico raises the question whether it is appropriate to adopt fast-track procedures for proposals initiated by the Government of Puerto Rico to repeal Federal legislation insofar as it relates to Puerto Rico, when such procedures necessarily must give this legislation precedence over other legislation applicable to the entire United States or, indeed, other possessions. It may also be appropriate to consider whether the provision should apply to tax legislation but not to legislation involving Federal benefits, citizenship, foreign relations, defense, and national security.

As to the desirability of using the fast-track procedure here, some may argue that if the United States is to remain in a Commonwealth relationship with Puerto Rico, and Congress is to have certain unique powers and responsibilities with respect to Puerto Rico that it would not have if Puerto Rico were a State or independent country, Congress should be required to deal promptly with effects of its legislation (including possibly unknown and unintended effects) on Puerto Rico. Were Puerto Rico an independent country, no such effects might exist in the typical case; were it a State, Puerto Rico would have its own representatives in Congress to exercise directly a Puerto Rican voice in U.S. legislation. On the other hand, it may be argued that priorities among categories of Congressional business generally need not be fixed in advance, absent unusual needs. It may be argued that the interests of Puerto Rico in repealing existing legislation (or existing tax legislation) do not rise to the level of such unusual need.

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[54] A list of resolutions which are currently privileged for consideration in the House of Representatives may be found in House Document 100-248, 100th Cong., 2d Sess. 865-66 (1988).

Finally, the tax law contains several provisions, described above, that have proven to be of particular interest to various Puerto Rican constituencies. By channeling certain expressions of these interests through the bill's procedures, the bill may be thought to give more weight, in some cases, to the views of the Governor and legislature of Puerto Rico. On the other hand, the bill may be viewed as restricting the freedom of Congress to fashion its own responses to these views.

4. Regulatory review

The bill sets forth certain broad policies, including the acceleration of Puerto Rican economic and social development, and (in matters of government) the taking into account of local conditions in Puerto Rico. The bill requires that all agencies (as that term is defined in the Administrative Procedure Act, 5 U.S.C. sec. 551), which for this purpose may include the Treasury Department and the Internal Revenue Service (IRS), be guided by those policies. If and to the extent Treasury and IRS may engage in rulemaking "pursuant to title 5, United States Code, section 553," [55] Treasury and IRS are to include in the concise general statement of the basis and purpose of any final rule, the views or arguments submitted to them that raise a question of the consistency of the rules with those policies.[56]

When Treasury publishes a final rule in the Federal Register (other than a rule issued after notice and hearing required by statute [57]) that by its terms applies in the Commonwealth of Puerto Rico, the Governor may, within a fixed period, require the Treasury to reconsider the rule in light of the policies set forth in the bill. The bill requires publication in the Federal Register, within a fixed period, of a Treasury finding with respect to the objections of the Governor. If the Treasury finds that it has no discretion to make the rule inapplicable to Puerto Rico, or to vary the terms of its application to Puerto Rico, or if it finds that there is a national interest that the rule be applicable to Puerto Rico as published, then under the bill the Governor, if aggrieved by such finding, can petition for review of that finding in the U.S. Court of Appeals for either the First Circuit or the District of Columbia Circuit.[58]

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[55] It has been said by at least one lower court that rules which are "interpretative" are "exempt from the rulemaking requirements of sec. 553." *National Restaurant Ass'n v. Simon*, 411 F. Supp. 993, 999 (D.D.C. 1976). It is not entirely clear whether the Committee on Energy and Natural Resources intended to include rulemaking involving such interpretative rules by its use of the phrase "pursuant to title 5, United States Code, section 553."

[56] The bill is unclear on the nature of the concise general statement required, and may need a technical change to clarify the intent of the Committee on Energy and Natural Resources. *Compare* bill section 404(b) *with* S. Rep. No. 101-120 at 50.

[57] There is apparently no general statutory notice and hearing requirement applicable to tax regulations in general. *See* Code sec. 7805; 5 U.S.C. 553(c) (1988).

This provision raises constitutional and administrative questions. For example, it may be appropriate to consider whether, and the extent to which, this provision expands the jurisdiction of the courts to hear complaints about tax regulations,[59] as well as the appropriateness of having issues about the impact of Treasury regulations on Puerto Rican economic and social development and other policy issues adjudicated in the Federal courts. Under current law, judicial determinations regarding the validity of Treasury regulations typically arise in specific tax controversies between a taxpayer and the IRS, and are generally circumscribed by deference to the agency's judgment as applied to the relevant statutes and legislative history.[60] Moreover, the general rule under the Anti-Injunction Act is that no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed (Code sec. 7421(a)). Declaratory judgments with respect to Federal taxes may be similarly barred in the general case (28 U.S.C. sec. 2201 (1982); *cf. Alexander v. "Americans United" Inc.*, 416 U.S.C 752, 759 n.10 (1974)). The bill, in contrast, would provide that without a specific taxpayer controversy, a court may be asked to weigh generalized policy objectives with respect to Puerto Rico against tax policies embodied in specific tax statutes and regulations and determine on the basis of that weighing process what remedy (if any) may be appropriate. Some may argue that Puerto Rico does not have an alternative legal way to challenge the validity of tax regulations, and that it therefore would be appropriate for the Governor to be permitted to litigate in advance the appropriateness of those regulations. *Cf. South Carolina v. Regan*, 465 U.S. 367 (1984) (holding that the Anti-Injunction Act did not bar a State from challenging under the tenth amendment to the Constitution a regulation restricting the form in which States could issue tax-exempt bonds). Others may argue that it is sufficient for such challenges to be made by affected taxpayers. They may also argue that the bill permits overly broad prospective relief from regulations insofar as the right of judicial review provided might not be conditioned on the existence of equitable jurisdiction (e.g., the bill might be read to provide the Governor a right of judicial review without requiring a demonstration that enforcement of the regulation would cause irreparable harm). Finally, some may argue that the weighing process necessitated by comparison of any regulation with the broad policy statement set forth in the bill would be more appropriately addressed outside the Judiciary branch of government.

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[58] On the other hand, there is no explicit procedure for judicial review prescribed by the bill for a case in which either the Treasury finds an inconsistency between the rule and the policy announced in the bill, and makes some change in the original regulation in accord with terms specified in its finding, or no finding as required by the bill is published in the Federal Register.

[59] It may be, for example, that the use of judicial review under this provision would be limited more or less severely by limitations based on justiciability doctrines (e.g., those regarding whether a matter brought before a Federal court is a case or controversy, whether it involves overly political questions, whether it is ripe, and whether the parties have standing).

[60] *E.g., National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979).

APPENDIX A:

Selected Federal Excise Tax Rates

Tax	Tax rates
A. Alcohol Beverage Excise Taxes:	
1. Distilled spirits	$12.50 per proof gallon.
2. Wines:	
Not more than 14 percent alcohol.	17 cents per wine gallon.
14 to 21 percent alcohol	67 cents per wine gallon.
21 to 24 percent alcohol	$2.25 per wine gallon.[1]
Artificially carbonated wines.	$2.40 per wine gallon.
Champagne and other sparking wines.	$3.40 per wine gallon.
3. Beer	$9 per barrel (31 gallons) generally.
B. Tobacco Excise Taxes:	
1. Cigars:	
Small cigars (weighing no more than 3 pounds per thousand).	75 cents per thousand.
Large cigars (weighing more than 3 pounds per thousand).	8.5 percent of wholesale price (but not more than $20 per thousand).
2. Cigarettes:	
Small cigarettes (weighing no more than 3 pounds per thousand).	$8 per thousand (i.e., 16 cents per pack of 20 cigarettes).
Large cigarettes (weighing more than 3 pounds per thousand).	$16.80 per thousand.[2]
3. Snuff, chewing tobacco, pipe tobacco:	
Snuff	24 cents per pound.
Chewing tobacco	8 cents per pound.
Pipe tobacco	45 cents per pound.

Selected Federal Excise Tax Rates—Continued

Tax	Tax rates
C. Highway Trust Fund Excise Taxes: [3]	
1. Gasoline	9 cents per gallon.
2. Diesel fuel	15 cents per gallon generally.
3. Special motor fuels (incl. alcohol fuels from petroleum)	9 cents per gallon.
D. Airport and Airway Trust Fund Excise Taxes: [4]	
1. Air passenger ticket tax	8 percent of amount paid.
2. International departure tax	$3 per person.
3. Domestic air cargo tax	5 percent of amount paid.
E. Communications Excise Tax:	
Local and toll (long-distance) telephone and teletypewriter services.	3 percent of amount paid.[5]

[1] Wines containing more than 24 percent alcohol are taxed as distilled spirits.

[2] Large cigarettes measuring more than 6.5 inches in length are taxed at the rate prescribed for small cigarettes, counting each 2.75 inches (or fraction) as one cigarette.

[3] These taxes are currently scheduled to expire after September 30, 1993.

[4] These taxes are currently scheduled to expire after December 31, 1990.

[5] This tax is currently scheduled to expire after December 31, 1989.

APPENDIX B:

Selected Puerto Rican Excise Tax Rates

Tax	Tax rates
A. Cigarettes	$3.15 per 100 cigarettes.
B. Gasoline	16 cents per gallon.
C. Aviation Fuel	3 cents per gallon.
D. Gas Oil or Diesel Oil	8 cents per gallon.
E. Crude Oil	Up to $6.00 per barrel, depending on the market price for crude oil.
F. Sugar	7 cents per pound.
G. Automobiles	14 to 85 percent of taxable price,[1] depending on weight and horsepower of automobile.
H. Other articles not subject to specific excise tax or exempt from excise tax.	5 percent of taxable price.

[1] For purposes of Puerto Rican excise taxes, "taxable price" generally means 72 percent of the sales price for articles manufactured in Puerto Rico and 132 percent of the article's factory f.o.b. price for articles imported into Puerto Rico.

Prepared Statement of Antonio J. Colorado

Mr. Chairman, it is my pleasure to appear before the Committee to discuss the importance of Section 936 of the Internal Revenue Code to the economy of Puerto Rico. As Administrator of the Economic Development Administration, my main responsibility is the creation and retention of manufacturing, service and related jobs in Puerto Rico. Section 936 is the key to Puerto Rico's economic development and my testimony will concentrate on the need to preserve this very important provision.

Section 936 and its predecessors have been effectively utilized by Puerto Rico to counteract the effects of overpopulation, lack of resources, distance from the mainland, and federal legislation which increases our costs of production and transportation, but clearly does not burden other countries that compete with us. Over the past forty years, the development of Puerto Rico's economy from agriculture to manufacturing has often been referred to as an "economic miracle." This accomplishment is attributable primarily to Section 936, and to Puerto Rico's industrial incentives legislation.

United States corporations are by far the most significant source of investment in Puerto Rico, although an increasing number of foreign and local industries are being established. In order to understand why the investment is so substantial and beneficial to both the United States and Puerto Rico, it is necessary to understand the interaction of our tax laws.

UNITED STATES TAX LAW

Section 936 exempts Puerto Rico manufacturing and service profits of an electing U.S. corporation from U.S. corporate income tax. Generally, these corporations are wholly-owned subsidiaries of U.S. corporations which conduct most or all of their business within Puerto Rico.

In addition, Section 936 provides an exemption for income from the investment of such profits for use within Puerto Rico and, since 1987, within those Caribbean countries which have entered into a Tax Information Exchange Agreement ("TIEA") with the United States.

These tax benefits, however, would be of no value without Puerto Rico's own tax incentives for doing business there.

PUERTO RICO LAW

Unlike a state, Puerto Rico enjoys fiscal autonomy. It is a separate tax jurisdiction outside of the federal sphere. The Government of Puerto Rico is solely responsible for its tax laws and has primary taxing jurisdiction on any income source within its boundaries.

In order to provide an incentive for investment in Puerto Rico, we have enacted a series of industrial incentive acts that provide certain investors with tax benefits for a period of years.

Investments of tax-exempt earnings made by Section 936 corporations in Puerto Rico's financial institutions are regulated by Puerto Rico to ensure that the same are utilized in productive areas that benefit our economy and those of qualified Caribbean Basin countries.

This favorable tax climate balances some of the adverse economic effects imposed on Puerto Rico by Federal legislation and regulations, such as the U.S. minimum wage, OSHA and EPA regulations, and the Jones Act.

IMPORTANCE OF SECTION 936 TO PUERTO RICO

Since the 1940s, Section 936 and its predecessors and the Puerto Rico Industrial Incentives Acts have been of critical importance in attracting U.S.. investment to Puerto Rico.

Our economy derives significant benefit from the manufacturing and service activities of Section 936 corporations. To illustrate the enormous significance of the manufacturing sector to the overall economy of Puerto Rico, a five percent reduction in Puerto Rico's gross product in manufacturing would be the equivalent of eliminating ALL agricultural production in Puerto Rico. A ten percent reduction in manufacturing would be equivalent to eliminating ALL tourism in Puerto Rico.

In addition, Section 936 funds on deposit with Puerto Rico financial institutions have a significant beneficial effect on every aspect of our economy. According to the U.S. Treasury, the cost of capital in Puerto Rico could be 1.0 to 1.5 percentage points below world rates, due to the availability of 936 funds.

There is, unfortunately, a direct correlation between the performance of the Puerto Rico economy and the legislative status of Section 936. After "Treasury I" was issued in November of 1984, new investment in Puerto Rico from the United States virtually halted. This reaction was also experienced in 1982, during the TEFRA legislative process. Thus, it appears that whenever Congress or Treasury raise the specter of modifying or repealing Section 936, immediate adverse economic consequences develop within Puerto Rico. It was only after Congress determined to preserve Section 936 in 1986 that investment from U.S. firms resumed. -

Real gross fixed investment in Puerto Rico grew by fifty percent between Fiscal Years 1985 and 1988. Real GNP grew by five percent in 1987, by 4.9 percent in 1988 and preliminary estimates for 1989 show a 3.7 percent growth rate. September employment statistics, released last week, show that total employment in Puerto Rico had grown to 916 thousand, an increase of twenty percent over the figure for September of 1984. Manufacturing employment in Puerto Rico stood at a historic high of 172 thousand, which represents an increase of 25 percent over the comparable figure for September 1984. The unemployment rate has fallen to 15.1 percent, still much higher than we would like, but significantly better than the 20.5 percent in September five years earlier.

IMPORTANCE OF SECTION 936 TO THE CBI

The Caribbean Basin Economic Recovery Act ("CBERA") was enacted in 1983 with no provision for investment incentives to stimulate the creation of enterprises that would be able to take advantage of the duty-free access to the U.S. market offered under the new legislation. In order to make CBERA more effective for the region, the Commonwealth of Puerto Rico proposed in 1985 the promotion of complementary projects between Puerto Rico and the CBI countries. This program integrates the comparative advantages of the region with the powerful incentives which result from the combination of Section 936 and our local tax benefits. In addition, the Commonwealth is stimulating the use of low cost financing available in Puerto Rico for eligible CBI countries.

In 1986 Congress determined that Section 936 funds could be used to finance active business assets and development projects in those Caribbean countries which have signed and ratified TIEAs with the United States.

This program is now gaining momentum and we believe it is well on its way to surpass the objectives contemplated by Congress in 1986. Over $165 million financing for Caribbean Basin projects have been promoted. Moreover, an additional $400 million of projects are in the process of being promoted or are awaiting ratification of TIEAs. So far, over 12,000 direct manufacturing jobs have been promoted in the Caribbean.

Because the opportunities for financing projects with Section 936 funds are so attractive, an incentive is created for CBI countries to sign the TIEA.

The Government of Puerto Rico has been instrumental in convincing many of the Caribbean countries of the importance and the benefits to be derived by signing the agreement. Meetings held with government and private sector representatives in the Dominican Republic resulted in the expedient ratification of their agreement. We have also been in conversations with representatives of Costa Rica's Congress and believe that there is a very good probability of them ratifying their agreement shortly.

TIEAs provide a law enforcement tool against tax evasion and money laundering, an important factor in the war against narcotics trafficking in the region.

IMPORTANCE OF SECTION 936 TO THE UNITED STATES

An economically strong Puerto Rico is crucial to maintaining the stability of the Caribbean region. It is irrefutable that Section 936 has worked, in combination with the Puerto Rico Industrial Incentives legislation, to create the strongest economy in the Caribbean.

In addition, Section 936 permits the funding of the CBI through the free market financial system, not through a direct government subsidy program.

We must also note that Puerto Rico is engaged in a significant trade relationship with the United States that is based on Section 936. In 1988 Puerto Rico imported close to $9.5 billion from the U.S., more than all of the countries of the Caribbean and Central America together, more than Argentina, Colombia and Brazil together, and more than twice the imports of Israel. This generates more than 170 thousand jobs in the mainland.

In addition to being a good market for U.S. products, Puerto Rico helps keep America competitive in global markets.

Exports from Puerto Rico to foreign countries grew by 37.5 percent between FY 1988 and 1989. This represented 11.8 percent of Puerto Rico's total off-island shipments of $16.3 billion.

Thus, on the whole, there are significant benefits enjoyed by the United States from Section 936.

In summary, Mr. Chairman, Section 936 of the United States Internal Revenue Code, in conjunction with Puerto Rico's incentives law, provides a significant economic benefit to Puerto Rico. It is now becoming clear that Section 936 funds are being used, and will be used in the future to a much greater extent, to provide financing for CBI projects as envisioned by Congress in 1986, thus providing a substantial benefit to the Caribbean Basin. Moreover, Section 936 benefits the United States by promoting regional stability and international trade.

Congress needs to have a clear understanding that Section 936 is a vital economic link between the United States and Puerto Rico which is of critical importance to Puerto Rico and the Caribbean and benefits the U.S. as well. Tampering with Section 936 can only cause economic harm to Puerto Rico.

Thank you Mr. Chairman. I would be pleased to answer questions.

Prepared Statement of Ruben Berrios-Martinez

I am here to testify on the trade, fiscal and economic provisions of S. 712.

We commend the Committee on Energy and Natural Resources and particularly Senators Johnston and McClure for their thorough and conscientious work on practically every aspect of the legislation under consideration. On the whole, we support the approach taken by their Committee directed to ensure that the people of Puerto Rico be presented with congressionally defined status options based on (1) a level playing field among such options, (2) a smooth transition to any new status, and (3) revenue neutrality applicable to all economic transition provisions. However, there is still need to further consider some aspects of the economic provisions of the bill.

Today and tomorrow we shall submit specific suggestions for the improvement of the economic provisions under independence contained in S. 712 based partly on the approach originally outlined by the Puerto Rican Independence Party at the beginning of this legislative process and partly on S. 712 as amended by the National Resources Committee.

This morning I wish to provide you with a general overview as a basis for our suggested improvements.

At the outset, it is necessary to succinctly outline the main parameters of the Puerto Rican economy.

The Puerto Rican economy is chronically ill. An appearance of normality is achieved only through massive subsidies from the U.S. Treasury and massive migration to the U.S.

Average unemployment in Puerto Rico during the last decade has been 19.5 percent, even though the average labor participation rate during the same period was 43% (compared to more than 60% in the United States). This means that if unemployment in Puerto Rico were measured by U.S. standards, average real unemployment in Puerto Rico, during the last ten years would have been 40 percent. To understand the magnitude of this statistic one need only remember that unemployment in the United States during the Great Depression hovered around 20 percent.

During the last ten years more than 400,000 Puerto Ricans have migrated to the United States.

United States subsidies and other payments to Puerto Rico in the last decade (not including Social Security payments and vested rights) amounted to $27 billion dollars. While income on U.S. investment in Puerto Rico during the same decade amounted to $58 billion.

In short during the last ten years the U.S. taxpayers subsidized the Puerto Rican economy to the tune of $27 billion dollars while United States companies in Puerto Rico obtained more than double that amount as income mostly from federally tax exempt 936 operations.

It should come as no surprise that under such extreme conditions of economic dependence, social decomposition has multiplied and that Puerto Rico is fast becoming a tropical ghetto.

For Puerto Rico, the net effect of the present economic situation is chronic economic dependence and social decomposition. For the United States, the net effect is an ever increasing burden for the average taxpayer.

Faced with these economic realities, the different status alternatives should be directed towards lessening the burden of such costs for both the United States and Puerto Rico. From that perspective the independence alternative is by far the most convenient both to the U.S. and Puerto Rico.

Taking the Congressional Budget Office figures as a basis and conservatively extrapolating them for a ten year period starting in 1992, the statehood alternative would cost the Treasury $37 billion dollars more than the present level of funding to the island economy, which by itself would amount to $56 billions dollars during the same ten year period. This means that both statehood and, if parity in funding is granted as requested by its leaders, also commonwealth would cost the U.S. Treasury in outlays the astronomic amount of $95 billion during the ten year extending from 1992 to 2001.

If one were to estimate the Federal budget deficit for 1992 at about $100 billion, the cost of Federal budget outlays for Puerto Rico in that year would account for 8% of the Federal deficit.

The independence option in contrast, represents at least $10 billion dollars in savings over the same ten year period, when compared to the present Commonwealth status, and $47 billion dollars in savings when compared to Commonwealth if parity is granted. With respect to statehood, independence represents a savings of $47 billion minus whatever amount is eventually estimated for Federal taxes payable by individuals and corporations in Puerto Rico. Thus, commonwealth with parity is by far the most expensive status option for the U.S. government.

Needless to say, U.S. block grants obligations under the present legislation would cease with the independence alternative after a nine year transition period, and while (and I quote from the Committee Report) "it is not required that all U.S. aid would cease at the end of the ninth fiscal year . . . future aid would be subject to negotiations . . . " taking into account "a history of very close relations and mutual interests between both nations."

On the other hand, under the Commonwealth and statehood options the U.S. taxpayer faces a bottomless pit of ever growing expenditures with no reasonable hope of offsetting them with locally generated revenue.

In short the answer presented by statehood and commonwealth to the chronic economic ills of Puerto Rico is therefore based on ever increasing economic dependence on the U.S. Treasury.

Independence proposes instead to break the straitjacket of extreme dependence through a rational and orderly transition. As stated in section 313 of S. 712, the economic provisions regarding independence:

> are enacted in recognition of the unique relationship between the United States and Puerto Rico, to affect a smooth and fair transition for the new Republic of Puerto Rico with a minimum of economic disruption, and to promote the development of a viable economy in the new Republic of Puerto Rico.

The transition grant contained in S. 712 to be paid to Puerto Rico during a nine year period, the trade and other economic arrangements which we have proposed, and the sovereign powers which the independence option entails, will provide Puerto Rico with the necessary tools to implement an economic development plan designed to put the Puerto Rican economy on its feet.

Independence is thus the only alternative which provides a blueprint for the future based on work and production rather than on economic dependence. We aspire to justice and national dignity, not charity and subservience, S. 712 provides the basic framework for such an endeavor.

Finally, I must address myself to a deeply disturbing issue which is before this committee's consideration. I refer to the proposal made by Governor Rafael Hernández Colónand his party requesting parity in the application of United States social programs to Puerto Rico under commonwealth. This request that Puerto Rico be treated as a state in all aspects except fiscal responsibilities and voting rights raises extremely serious questions. First, issues of a strictly economic nature arise in the attempt to bring parity to the unincorporated territory of Puerto Rico. This would make commonwealth more costly than statehood itself since Puerto Rico would receive the same funds as a state but would not contribute to the Federal government. Secondly, however, an even more crucial question of a political and moral nature is brought dramatically to the fore.

It is my conviction that statehood is neither in the best interests of Puerto Rico nor in the best interests of the United States. It is also my conviction that this understanding is now in the process of being internalized by ever growing numbers of Senators and Congressmen as a result of the debate and discussion unleashed by this legislative process. This is taking place precisely at the historical moment when the inclination towards statehood is at its highest point in Puerto Rico.

Many who are becoming wary of a statehood majority in Puerto Rico, and who have historical misconceptions regarding independence may be tempted to look kindly upon the request for parity as a desperate attempt for a last clear chance to equip the defenders of commonwealth with an electoral weapon powerful enough to make victory possible over statehood in the proposed plebiscite. If one adds to this motive the fact that the notion of parity has a ring of equality and fairness attached to it, parity might appear as an irresistible, if costly, solution to the dilemma of how to prop up commonwealth status so that it will keep the statehooders in the minority—not to mention to independentistas—for another generation.

Congress has a perfect right—perhaps even a responsibility—not to grant statehood to Puerto Rico no matter how large a majority of Puerto Ricans might favor it.

However, no one has a right to propose that Congress purchase the political dignity of the Puerto Rican voters by promising the 60% of Puerto Ricans who still live in poverty a cornucopia of Federal transfer payments if they vote for the present status of political subordination and renounce their right to political equality and representation which they would enjoy under statehood, independence, or sovereign free association as defined by international law.

No one in this Congress would back down an inch in their position to apartheid simply because the South African government decided to extend to poor blacks the economic benefits that it grants to poor whites. How is it possible then to argue that economic largesse to the Puerto Rican poor should justify the possibility of retaining a politically subservient territorial or colonial regime in Puerto Rico where real legislative, executive, and judicial power is exercised by the government of the United States from the election of whose President and Congress the Puerto Ricans are excluded?

To talk of parity in Federal funding to Puerto Rico in the context of present day or "enhanced" commonwealth is to permit colonialism to be shielded from congressional inquiry by the artful sophistry of appealing to a highly selective sense of equality and fairness.

If Congress feels the obligation, as it should, to provide generous economic terms to the different status options let it be generous in the terms it provides independence and statehood, and let it be generous in helping to finance a real sovereign free association relationship as defined by international law. However, under no conditions should it allow a status of political subordination to appear on the ballot, much less with the seductive inducement of providing the economic benefits of statehood without the financial responsibilities.

Whatever economic terms the Congress chooses to provide, any legitimate status alternative should spring from a combination of its sense of justice as well as from enlightened self interest. This role should clearly preclude that of promoting continued colonialism. I urge this Committee, as I indeed urge the Congress, to reject any proposal that would even provide the appearance of attempting to extort the rightful claims of Puerto Ricans to full political rights under statehood, independence, or sovereign free association by making an artificially sweetened colonial offer.

If Congress merely wants to prop up the present territorial status by multiplying Federal subsidies, it should limit itself to that endeavor and put aside any pretenses regarding self-determination. To do otherwise would make a mockery of this principle and render the proposed referendum totally unnecessary.

POSITION OF THE PUERTO RICAN INDEPENDENCE PARTY ON TAXATION ISSUES

In contrast to the patterns of growth that Puerto Rico attained in the first two decades after World War II, and in spite of current efforts by status guo advocates to artificially prolong the life of the rose-colored propaganda of those early post-war years, Puerto Rico's economy can hardly be described today as a showcase of success. With half of its population dependent on public outlays for basic subsistence, and with higher drug abuse and crime rates than even those that usually afflict societies with pervasive unemployment, the island must instead be observed as suffering from a severely dislocated economic structure. This structure permits a relatively small sector of the population to profit from the industrial, financial and service networks organized around Section 936 of the U.S. Internal Revenue Code; but it also forces a much larger sector of the population to suffer the consequences of dramatic unemployment and even greater underemployment.

Puerto Rico's economy relies excessively on Section 936. This makes our economy not only skewed and disarticulated, but also unstable and vulnerable to decisions made by a Congress in which Puerto Ricans are not represented. For many years we were told that we simply could not aspire to anything better. Today, however, the outstanding accomplishments of small nations in South East Asia and in other areas of the world make it difficult to believe that Puerto Rico—with its relatively well developed infrastructure and its highly skilled labor force—must be doomed to depend for its economic progress on just a single (and fragile) U.S. statutory provision.

In the Puerto Rican Independence Party, we are convinced that independence is the most economically convenient path for the island. In fact, we see independence as a necessary step for solving the problems mentioned earlier. Yet we do not lose sight of the fact that while independence is *better* than Commonwealth, it is also *different* from Commonwealth. In complex political endeavors, as in more mundane matters, changes toward something different usually work better when implemented smoothly, rather than drastically.

By making Puerto Rico independent we could definitely offer, both the island and outside investors generally, a much better industrial package than that which is available today. The ability of United States companies to defer United States taxes on their Puerto Rico earnings until the time of repatriation, combined with the additional effect of the foreign tax credit mechanism available under the laws and treaties of the United States, would allow the island to offer tax-related incentives comparable to those currently in place. Furthermore, Puerto Rico's sovereign control over areas of commerce now subject to United States legislation, such as maritime transport and foreign trade, would make it easier to promote local industries and to substantially reduce operating cost on the island, thus enhancing our industrial attractiveness.

Perhaps more importantly, an independent Puerto Rico would be able to greatly expand and diversify its capital and export markets. This area is of particular significance in view of the fact that countries like Japan, West Germany, France and the United Kingdom have developed section 936 equivalents for which Puerto Rico would qualify if it were an independent nation. Finally, we wish to underscore that the block grant provisions in the current draft of S. 712 would allow the island to utilize substantial funds for investing in its industrial future, rather than for perpetuating the dependence and stagnation currently caused by a large portion of the Federal transfer programs.

Regrettably, Puerto Rico's economy has been molded not on the set of incentives we just outlined, but on the combination of Federal and local tax exemption made possible by section 936. The change toward a new set of incentives would necessarily take time. Government planners would need to readjust their promotion strategies and infrastructural priorities, and companies which have established themselves on the island lured by section 936 would have to adapt to new avenues of profitability.

With these realities in mind, the Puerto Rican Independence Party formulated in its initial draft proposal for S. 712 that the tax credit allowed under section 936 should remain in full effect for a 15-year period after the proclamation of independence. This period is similar to that which has been granted in the Micronesian free association compacts adopted by the U.S. Congress in recent years.

In spite of the fact that, unlike the Micronesian islands, Puerto Rico has been made to depend heavily on section 936 for more than a decade, S. 712 does not currently contemplate a phase-out of section 936 after the proclamation of independence. Thus, according to Congressional Budget Office estimates, the 936 credit would be expected to disappear by 1994.

We urge the Finance Committee to seriously reconsider this aspect against the just described background of dependence which requires a transitional arrangement. Furthermore, from the standpoint of the U.S. Treasury, it makes *virtually no difference* to maintain or eliminate the 936 credit if Puerto Rico became independent.

This latter point is crucial to understand. If section 936 were eliminated and Puerto Rico treated like any other foreign country under U.S. law, then all earning repatriations to U.S. shareholders from Puerto Rico corporations would be subject to U.S. corporate taxes. However, the shareholders would be able to offset against their U.S. tax liability a credit equal to the amount of taxes paid in Puerto Rico on the income to which the dividends corresponded. Since at least during the early years after independence most foreign companies on the island will continue to be owned by U.S. residents, the Puerto Rican government would almost surely tax their incomes at corporate rates similar to those of the United States. This would be accomplished either through a direct corporate tax or, in order to maintain the deferral incentive, through a withholding tax on dividends. This way, the United States would collect no revenue whatsoever, while Puerto Rico would collect it all. Puerto Rico could, in turn, use those revenues to invest in its infrastructure or to finance and subsidize companies located there in order to erase any economic disadvantage caused by the virtual neccesity of imposing corporate taxes.

As indicated, this new set of circumstances could in the long run allow Puerto Rico to maintain—or even to enhance—its investment attractiveness. The complexity and the importance of the stakes involved, nevertheless, demand a careful transition. The U.S. government created the monster of colonial dependence in Puerto Rico, and it is consequently the U.S. government which has primary responsibility for prudently phasing out all aspect of such dependence. We would have been on our feet long ago if the United States had not taken over our economy and structured it in a manner different from that which we ourselves would have selected. What we want is for Puerto Rico to stand solidly on its feet as an independent nation, without special concessions from the United States.

PREPARED STATEMENT OF JOSE BERROCAL

Mr. Chairman and Members of the Committee, I am Jose Berrocal, Counsellor to the Honorable Rafael Hernandez Colon, Governor of the Commonwealth of Puerto Rico. It is my pleasure to appear before you today to discuss ways in which the Commonwealth of Puerto Rico, created in 1952 as a compact between the people of Puerto Rico and the Congress of the United States, can enhance and strengthen its economic development within the context of today's increasingly interdependent and interrelated world economy.

The international economy of the 21st century will be more competitive and diversified. The increasing globalization of world markets, the unification of Europe, the opening of the iron curtain, the surge of democracy in Latin America, the new awakening in the Caribbean, are all dramatic and progressive changes toward a more interdependent world. As part of these changes, we seek an expanded role for the Commonwealth of Puerto Rico in the ~~area of in~~ternational trade.

As a small and densely populated society with limited natural resources, Puerto Rico's prospects for economic growth are necessarily tied to the search for outside markets and trade. Our economic history during the last forty years is one of dramatic growth and industrialization, fueled by an influx of capital and technology and an outflow of goods and services. An industrious and determined people, in the span of two generations, we have gone from being the poorest of the poor in the hemisphere to enjoying today the highest standard of living in all of Latin America. Trade has been the key to our development.

Puerto Rico's exports have boomed from $235 million in 1950 to $13,186 million in 1988, while our imports have grown from $345 million to $11,859 million during the same period. Our total Gross National Product has grown twenty-five-fold since 1950.

Close to 80 percent of this trade has been with the United States, thanks to our common market. Yet in our quest for added self-sufficiency we need to diversify our markets and our sources of capital. Our economic development has been staggering, but with a per capita income approximately one-third that of the U.S., Puerto Rico has a long way to go.

The Commonwealth Title of S. 712, as reported by the Senate Energy and Natural Resources Committee, contains three provisions designed to enhance Puerto Rico's economic development and to accelerate the Commonwealth's participation in the world economy by expanding access for our products in foreign markets.

First, although Puerto Rico's income qualifies it for GSP treatment, our exports do not receive such preferential treatment. GSP status has already been obtained by, among others, the U.S. Virgin Islands, Guam and American Samoa. The proposed legislation would require the United States executive branch to encourage other countries to grant similar GSP status to Puerto Rico.

Second, Puerto Rico needs special, limited tariff-setting authority, to the extent consistent with U.S. international obligations, so that it may provide adequate protection and encouragement to the production of a narrow category of Puerto Rican products, primarily agricultural in nature, of slight interest to the United States, but vital to Puerto Rico.

Third, because Puerto Rico is bound by United States trade agreements, Puerto Rico, with its unique economic framework, seeks to be consulted when the United States negotiates such agreements.

I. GSP STATUS

Under the Generalized System of Preferences ("GSP"), industrialized nations provide unilateral, non-reciprocal preferential treatment to imports from developing countries, territories, and political entities. The GSP program is designed to accelerate the economic development of these entities by encouraging greater diversification through additional export opportunities.

GSP programs provide valuable benefits—benefits which could potentially be extremely helpful in the development of the Puerto Rican economy. Even though the per capita GNP of Puerto Rico is similar to that of other developing economies that have been accorded GSP status, the Commonwealth does not receive preferential GSP treatment. The proposed legislation would require the United States executive branch to seek to obtain favorable treatment from foreign countries for exports from the Commonwealth and to encourage other countries to consider Puerto Rico as a developing territory for purposes of their respective GSP programs. A similar provision has been enacted into law by Congress for the benefit of the Commonwealth of the Northern Marianas. Moreover, GSP status has already been obtained for the U.S. Virgin Islands, Guam, American Samoa, and the U.S. Pacific Trust Territories.

While it may appear to be a relatively modest request to ask the United States Government to encourage other countries to consider Puerto Rico as a developing area for purposes of their respective GSP programs, it has not been possible to obtain such assistance from the United States Government in the absence of an affirmative congressional policy statement.

For example, in 1987, several Japanese companies had indicated in writing their willingness to consider manufacturing in Puerto Rico for the Japanese domestic market if Japan would grant GSP status to Puerto Rican products, and it appeared that the Japanese Government was prepared to do so if it received such a request from the executive branch of the United States Government. All that was needed to test this promising possibility was a letter from the United States Trade Representative to the Government of Japan requesting this action. This limited request, followed a prior expression by the Secretary of State of his desire to assist Puerto Rico in securing greater Japanese investment. Nonetheless, an inter-agency committee of the U.S. Government decided against taking this simple step to help Puerto Rico and, incidentally, to thereby reduce the United States trade imbalance with Japan, on the ground that Japan probably would acquiesce to such a request and the Administration did not wish to find itself indebted to Japan for even such a modest act.

Because GSP benefits are to be accorded on a nonreciprocal basis without expectation of compensation, there is no sound policy reason for the United States Government not to encourage other countries to grant Puerto Rico GSP status. In light of this prior history, we therefore request that the reported language be made mandatory as originally proposed by the Commonwealth, by deleting the phrase "it is the sense of the Senate that" currently found in Section 406(b) of S. 712, as adopted by the Senate Energy and Natural Resources Committee at the request of the Administration.

II. SPECIAL TARIFF-SETTING AUTHORITY

Since 1930, Puerto Rico has enjoyed tariff-setting authority with respect to foreign coffee. This has allowed Puerto Rico to develop coffee production nearly sufficient to meet local demands. The proposed legislation would extend the existing authority to cover those products of special interest to the Commonwealth, where doing so would be consistent with U.S. international obligations.

Puerto Rico has long been part of the "customs territory of the United States." As such, Puerto Rico's ability to develop an international trade policy to enhance the island's economic development has been severely restricted. For example, since the turn of the century, Puerto Rico has generally been required to levy the same customs duties on imported articles as the U.S. mainland.

In contrast to the U.S. Virgin Islands and other insular possessions which may set duties so as to take into account the special needs of their developing island economies, Puerto Rico is prohibited by statute from imposing duties which differ from those of the United States. A number of products and crops which may be of relatively slight interest to the United States are vital to Puerto Rico. The U.S. duties on these products are frequently so low that they fail to provide any protection for, or encouragement to, Puerto Rican producers and place the Commonwealth at a distinct competitive disadvantage vis-a-vis its Caribbean neighbors.

Under Section 406 of S. 712, as reported by the Senate Energy and Natural Resources Committee, the Commonwealth of Puerto Rico would be authorized to impose tariff duties on foreign-origin products to the extent that it can do so without violating the international obligations of the United States. Such duties would be in addition to the regular duties applicable to products entering the customs territory of the United States. The special tariff-setting authority would apply to foreign origin products which are imported directly into Puerto Rico and those which are transshipped to Puerto Rico through the United States. It would not affect U.S.-origin merchandise which would continue to enjoy duty-free access to the Commonwealth.

III. CONSULTATION WITH RESPECT TO TRADE NEGOTIATIONS

As part of the "customs territory of the United States," the Commonwealth of Puerto Rico is bound by the tariff and non-tariff agreements negotiated by the United States. In the past, Puerto Rico has not played an active role in the formulation of U.S. trade negotiation strategy. As a result, the special economic interests and needs of the Puerto Rican economy have not always been recognized by U.S. negotiators or accorded adequate weight. For example, the United States has agreed to very low tariffs on certain agricultural products such as plantains which are produced in Puerto Rico but not the mainland.

Section 406 of S. 712, as reported by the Senate Energy and Natural Resources Committee, would amend Section 1102 of the Omnibus Trade and Competitiveness Act of 1988 by adding a new "sense of the Senate" provision, urging the President to consider the effects of proposed tariff rates and proposed changes in non-tariff measures on the economy of Puerto Rico. In particular, the President would be required to consult with the Governor of the Commonwealth of Puerto Rico concerning the potential impact of such changes before concluding international trade negotiations.

The proposed legislation provides a formal mechanism for participation by Puerto Rico in the negotiation of international trade commitments that are binding on the Commonwealth without unduly restricting the flexibility of U.S. negotiators. While it would require the President to consult with the Governor of the Commonwealth of Puerto Rico and to consider the potential impact of tariff and non-tariff measures on the Puerto Rican economy, the legislation would not impose any substantive limitations on the President's trade negotiating authority. In view of these relatively modest objectives, we object to the phrase "it is the sense of the Senate that" added by the Senate Energy and Natural Resources Committee at the request of the Administration to water down the mandatory statutory language the Commonwealth sought. We request that the Senate Finance Committee restore the original language proposed by deleting this weakening phrase.

CONCLUSION

In summary, the Commonwealth Title of S. 712 contains three relatively modest, yet important, international trade provisions designed to enhance Puerto Rico's economic development and to accelerate the Commonwealth's participation in the expanding world economy. We strongly advocate the adoption of these three provisions with the minor revisions discussed above.

Prepared Statement of Francisco Catala

POSITION OF THE PUERTO RICAN INDEPENDENCE PARTY ON THE QUESTION OF UNITED STATES FEDERAL GOVERNMENT GRANTS AND TRANSFER PAYMENTS TO PUERTO RICO

The structural deficiencies resulting from the economic development strategies implemented in Puerto Rico are reflected in the high degree of dependence on U.S. Government grants and transfer payments to the Commonwealth Government and to individuals.

During fiscal year 1988 (Puerto Rican fiscal year), Federal Government grants and transfer payments to Puerto Rico amounted to $5,665 millions. If we exclude from that figure, the net operating expenditures of Federal agencies in Puerto Rico, $684 millions, we get the Federal transfers received by the government sector for joint projects and operational expenses ($1,199 millions), and the transfers to individuals ($3,711 millions). There are also subsidies to industries, the bulk of which goes to public enterprises, that during fiscal 1988 amounted to $71 million. Of the total transfers to individuals, the share of vested rights represents about 68 percent.

A reduction of such dependence is a major goal of the Puerto Rican Independence Party, but this reduction needs to be accomplished gradually and in an orderly manner.

We propose that transfer payments to individuals arising from vested rights should continue fully in effect until the normal expiration of such benefits. This proposal is in keeping with S. 712, Section 313. Regarding all other U.S. Government grants and transfers, the Puerto Rican Independence Party proposed in its initial proposal before this Congress that federal transfers to Puerto Rico be maintained for ten years after the proclamation of independence at their level in the year of such proclamation. Thereafter, the transfers would decrease by ten percent each year until their total phase-out in the year 20. S. 712 currently calls for a nine-year continuation of transfers at such present level. In light of obvious administrative considerations which mandate a concern for smoothness in phasing out Puerto Rico's dependency, we regard the complete transition we had earlier proposed as preferable. We call upon this Committee to face the fact that even with the complete transition we request, independence remains by far the most convenient option from the point of view of the U.S. Treasury. All efforts to make the transition to independence a smooth and viable constitute an historical, political and economic advantage for both for Puerto Rico and the United States.

POSITION OF THE PUERTO RICAN INDEPENDENCE PARTY REGARDING SOCIAL SECURITY

Section 314(a) Provides that the Joint Transition Commission established under Section 305, through a Task Force on Social Security, will negotiate the necessary agreements for the transfer of functions and resources from the Social Security system of the United States to a new social insurance system to be established by the government of the Republic of Puerto Rico (RPR). This section also insures that the benefit rights of workers who have attained permanently insured status under the Old Age, Survivors, and Disability Insurance programs as of 5 years subsequent to the certification to the referendum shall be guaranteed. The transition from the current arrangement to a new system would guarantee that current beneficiaries would continue to receive full benefits until the normal expiration of such benefits.

This might entail a transition cost, since current contributions by Puerto Ricans to the present system are less than the current benefits. However, such cost is both fair and consistent with the overarching legislative purpose of gradually reducing Puerto Rico's dependence on the United States, particularly in light of the fact that current beneficiaries have made lifetime contributions to the system and in light of the fact that any transition cost would be temporary. The Task Force established by the Joint Transition Commission to deal with these matters would select among various possible alternatives to provide such guarantees, so that the RPR could establish and operate a financially sound social insurance system for the protection of future generations of its citizens.

With respect to the contribution paid into the United States Social Security System by residents of Puerto Rico who have not attained permanently insured status as of the expiration of the 5-year period established in this section, the most sensible approach would be to transfer those contributions, with interest, to the new social insurance system of the RPR. Upon such transfer, any obligations of the United States Social Security System toward those workers would cease. This transfer would provide the RPR with an adequate start-up fund for its own social insurance system.

POSITION OF THE PUERTO RICAN INDEPENDENCE PARTY ON TRADE ISSUES

Puerto Rico is one of the most open economies in the world, with a combined volume of imports and exports nearly twice the size of its Gross Product. By far, the majority of this trade has been with the United States, which provides the bulk of Puerto Rico's imports and the main markets for its exports.

In the last three fiscal years (1986-1988), the United States has accounted for between 87% and 88% of Puerto Rico's total merchandise exports.

On the other hand, Puerto Rico has become a major market for the United States. In fiscal year 1988, the Island's merchandise purchases from the United States amounted to $7.9 million, a figure equivalent to 43% of local Gross Product in that year. This level of merchandise imports exceeded that of at least ten other major trading partners of the United States, according to U.S. Department of Commerce data for 1988. Such countries as France, Italy, Brazil, Venezuela, China, Hong Kong, and Singapore were surpassed by Puerto Rico In terms of merchandise imports from the United States. Similarly, Puerto Rico's imports from the United States were only $1.4 billion less than the coined total of Australia, New Zealand and South Africa. Considering that Puerto Rico's population of about 3.3 million is considerably smaller than that of most of the U.S. major trading partners, the Island is probably the biggest U.S. customer in per capita terms.

Direct access of Puerto Rico's products to the U.S. market has been a key feature of the economic relations between the two countries and a cornerstone of the Island's industrialization strategy. Nevertheless, it should be noted that the special advantage provided by free access to the U.S. market has been eroded in the last two decades as the U.S. Government has granted free access to its market to other countries as part of GATT negotiations and, more recently, under the Caribbean Basin Initiative.

It is in the best interests of both the United States and Puerto Rico that good trade relations be maintained between the two nations after the proclamation of independence. A special trade regime between the Republic of Puerto Rico and the United States will not only strengthen the bonds of friendship and mutual respect between the two countries, but will also facilitate the continued economic development of Puerto Rico and will enable the Republic to play a positive role in the development of other Caribbean and Latin American nations. With respect to the latter, it should be pointed out that the Caribbean and South America are the two most important trading regions from Puerto Rico's viewpoint after the United States.

The current draft of S. 712 allows Puerto Rico to opt for beneficiary status under the Caribbean Basin Initiative, or to enter into a mutual free trade agreement with the United States. It also offers most favored nation treatment for Puerto Rico after it becomes independent. These provisions, although capable of providing the direct access guarantees which our earlier proposal suggested, should be further clarified to expressly indicate our intent to safeguard the maximum access of Puerto Rican products to the U.S. market as proposed in the report of the Committee on Energy and Natural Resources. *The desirable free trade arrangement between the United States and the Republic of Puerto Rico would not mandate open trade of all goods between the two nations, but that to the extent there are limitations on imports or exports, those limitations would be as mutually agreed and would, overall, provide mutual benefits to both nations and would assist each in meeting its trade and economic development objectives.*

MEMORANDUM

To: Senate Finance Committee
From: Puerto Rican Independence Party, by Manuel Rodriguez Orellana, Esq., Counsel to the President; Erick Negron, Esq., Special Advisor on Tax Matters
Re: S. 712—Tax Aspects under Puerto Rico Status Bill
Date: December 6, 1989

This memorandum summarizes the position of the Puerto Rican Independence Party with respect to the tax questions arising from Section 936 of the U.S. Internal Revenue Code under S. 712. Such summary encompasses not only the principal arguments advanced by representatives of our Party during the Committee hearings of November 14, 1989, but also our reaction to the concerns expressed by the Treasury Department with respect to the allowance of a phase out for Section 936 in the event Puerto Rico opts for independence.

With regard to matters under Finance Committee jurisdiction but not related to Section 936, our Party introduced its written and oral comments on the relevant aspects of bill U.S. 712 during the hearings of November 15, 1989. The bill's language should more specifically incorporate the detailed legislative intentions embodied in the Report of the Committee on Energy and Natural Resources. We believe, however, that the bill, as clarified by the Report, provides generally fair treatment to the independence option regarding the above-mentioned nontax matters.

Regrettably, the same cannot be said about the Section 936 issue. While a constitutionally dubious six-year phase-out is allowed under statehood for Section 936, and while Section 936 is not even mentioned under the commonwealth formula (thus helping to obscure the fact that, like any other alleged attribute of commonwealth status, Section 936 is currently subject to congressional action), under independence Section 936 vanishes immediately. Specifically, Section 317 of S. 712 states that "[e]ffective on the date of proclamation of independence, the tax credit allowed under Section 936 of the United States Internal Revenue Code shall not be available with respect to income or investments from activity in Puerto Rico."

The Report indicates that the decision not to allow a phaseout for Section 936 under independence was "in response to concerns of the Department of the Treasury that extension of Section 936 to an independent Puerto Rico might trigger 'most-favored' clauses in tax treaties with other nations and would thus require Section 936 to be extended to them." These concerns were reiterated by the Treasury Department during the Finance Committee hearings of November 14, 1989.

The Report, however, does not provide any other bases for doing anyway with a phase-out of Section 936 after the proclamation of independence. Thus, the objections of the Treasury Department appear to be the sole reason for the discriminatory way in which independence is treated with respect to Section 936 *vis a vis* statehood and commonwealth.

We believe that the Treasury Department's approach is plainly incorrect with regard to this issue. First, while the United States government has traditionally refused to adopt tax sparing as a general policy in its tax arrangements with foreign nations, it has also been the specific policy of United States to maintain the applicability of Section 936 to territories formerly under U.S. rule that attain sovereignty while subject to such tax provision. The continued availability of Section 936 for a 15-year period is expressly conferred in Section 255 of the Compact of Free Association between the government of United States and the governments of the Federated States of Micronesia and the Republic of the Marshall Islands. See 48 U.S.C. sec. 1681. A similar provision appears in section 255 of the draft compact between the United States and the Republic of Palau. Id.

In its report on S. 712, the Committee on Energy and Natural Resources notes that "Section 936 is continued to the Freely Associated States of Micronesia and this has not posed problems with respect to 'most-favored' clauses in tax treaties. The report then goes on to indicate that "[t]he Freely Associated States, while fully sovereign, are not independent and while under free association are eligible to participate in many federal programs as though they were a part of the United States. Puerto Rico, on the other hand, would be fully independent." This political difference between an independent Puerto Rico and the Freely Associated States, while correctly stated in the Report, is not legally relevant as regards to the "most favored" clauses so that Puerto Rico's capacity to enjoy tax sparing under independence should be restricted.

Under international law, a sovereign nation may enter into a free association compact with another nation covering not just tax sparing but almost for many other aspect. Even if such a compact entailed a revocable delegation by one contracting nation to the other of decisional prerogatives normally associated with independence, such delegation would not make the former any less of a sovereign nation. The fact that a nation may be freely associated with another does not detract from its international personality as a nation possessing sovereignty.

Even if the alleged distinction between independent and freely associated nations were legally relevant, the only thing Puerto Rico or any other independent nation, would need to do to qualify for tax sparing would be to enter into a free association compact with the United States with a single provision allowing for a tax sparing arrangement. Free association compacts, after all, need not contain any specific minimum of provisions; everything is left to the will of the contracting nations, provided that neither renounces its sovereignty.

The "free association" element is not the reason for that absence of complaints from "most favored" clause beneficiaries regarding the 15-year extension of Section 936 to the Micronesian nations. *Nobody has complained because no one is worse off by such extension.* In other words, since such extension only lasts for the duration of the free association compact (15 years), it can be regarded in effect as a reasonable phase-out of just one important item within the comprehensive set of pre-existing economic and political relationships which in fact provided indefinite 936 benefits.

As noted in the report by the Committees on Energy and Natural Resources, "[t]he State Department testified that a reasonable phase-out of Section 936 would not likely raise objections from other nations because such a transition situation was not contemplated under any previously negotiated tax treaties." Since the question of whether those treaties would be violated by such phase-out is not an issue of tax policy—which would properly correspond to the expertise of the Treasury Department—but of treaty interpretation—for which the State Department is better equipped--we strongly suggest that the views of the latter should prevail. The entire transition apparatus under the independence formula in S. 712, after all, is designed precisely to reorient Puerto Rico from its current special treatment under U.S. law toward self sufficiency and equal footing with other nations. This goal is squarely consistent with the policies behind "most favored" clauses in both tax and trade conventions.

In considering the above arguments, we urge the Finance Committee to take into account the fact that from a budgetary standpoint it makes *virtually no difference* for the United States to maintain or eliminate the 936 credit in the context of an independent Puerto Rico. If Section 936 were eliminated and Puerto Rico treated like any other foreign country under U.S. law, all dividends paid to U.S. shareholders from Puerto Rico corporations would be subject to U.S. corporate taxes. However, the shareholders would be able to offset against their U.S. tax liability a credit equal to the mount of taxes paid in Puerto Rico on the income to which the dividends corresponded. Since at least during the early years after independence most foreign companies on the island would probably to be owned by U.S. residents, the Puerto Rican government would be tempted to tax their income at corporate rates similar to those of the United States. In this were done, the United States would collect no revenue whatsoever, while Puerto Rico would collect it all. Puerto Rico could, in turn, use those revenues to invest in its infrastructure or to finance and subsidize companies located there in order to erase any economic disadvantage caused by the virtual neccesity of imposing corporate taxes.

As explained in our testimony at the hearings of November 14, 1989, this new set of circumstances, combined with the considerable commercial and fiscal advantages Puerto Rico would attain upon becoming independent, would allow the island to structure a more balanced and reliable set of investment incentives than that which exists. The change toward such new incentives, however, would be difficult to accomplish overnight. Government planners would need to readjust their promotion strategies and infrastructural priorities, and companies which have established themselves on the island lured by Section 936 would have to adapt to new avenues of profitability. These realities demand implementation of a smooth and responsible transition.

Independence is in the best interests of both the Puerto Rico and the United States. These interests are best insured through friendly ties that recognize the special relationship which Puerto Rico will continue to share with the United States.

On the economic side of such relationship, Congress must not overlook the role that Section 936 has played for Puerto Rican economy, for the manufacturing enterprises operating on the island and for the substantial sectors of the U.S. economy that are linked to the 936 industrial network. At practically no revenue cost, a reasonable path can be drawn for Puerto Rico to overcome its current overdependence on tax sparing from the United States, thereby rendering independence a simpler solution for all sides affected.

We urge the Finance Committee take action in this respect by amending S. 712 with the introduction of a reasonable phase-out provision for Section 936 under the independence alternative.

PREPARED STATEMENT OF LUIS A. FERRE

Mr. Chairman and distinguished members of the Finance Committee: My name is Luis A. Ferre. I served as Governor of Puerto Rico from 1969 to 1973, and I am a graduate of the Massachusetts Institute of Technology.

In a moment you will hear from former Governor Carlos Romero, President of Puerto Rico's statehood party. I am honored to testify on behalf of S. 712, an historic measure that would provide the people of Puerto Rico with their most cherished wish the right of political self-determination and, I believe, eventual statehood.

Mr. Chairman, I have worked for over 50 years on behalf of statehood for Puerto Rico. I strongly believe statehood serves the best interests of Puerto Rico and of the United States.

Like all Puerto Rican Americans, I love this country. Many Puerto Ricans have died fighting to preserve liberty in the United States Armed Forces, amongst them Fernando Garcia Ledesma who won the Congressional Medal for the ultimate sacrifice of his life. My grandson, a graduate of West Point, serves now in the Armed Forces in Germany. He is witnessing an important episode in Democracy's progress—its inevitable fulfillment—firsthand. So am I. What Congress is doing for 3.3 million of its own citizens in this process is as important, in its own way, as events unfolding in Germany, Poland, and elsewhere: *Congress is ensuring the right of self-determination.*

After 50 years, people sometimes ask why I have such faith in statehood. I have positive and negative reasons.

First, the negative: it is simply wrong to deny 3.3 million American citizens, who have proven their willingness to fight and die for their country, such basic civil liberties as the right to elect a representative congressional delegation with voting rights and the right to vote for the President who sends them into battle.

More positively, the promise of a healthy, balanced economy lies in statehood not continued territorial status and dependency. I am a common sense businessman. My family and I have been blessed and our business has been successful, not by inheritance, but by hard work. I have served on the Board of Trustees for MIT for 25 years. I have served on bank boards and U.S. commissions such as UNESCO and the U.S. Puerto Rico Status Commission. My son serves on the Boards of American Airlines and Metropolitan Life Insurance Company. Our cement company trades on the New York Stock Exchange. We have learned something about business.

It is this. Subsidy does not beget success—only precarious subsistence. My businesses have not depended upon subsidy for their success and, ultimately, neither should other businesses which comprise Puerto Rico's economy.

Puerto Rico's economy can flourish under statehood, just as the economies of other territories have, once they became states. Economies dependent upon tax exemption and government subsidy—denied the unbridled and properly deserved opportunities that only statehood can offer—ultimately are weighed down by the uncertainties of the very programs which support them.

I have devoted my life to statehood because I know the spirit and ability of the Puerto Rican people and the sense of fairness of this great nation. With each passing decade of this century, at my age of 85, I have seen Puerto Rico grow from an agricultural community of scant resources and suffering of poverty and limited opportunities to a dynamic society inspired and guided by the spirit of American Democracy to give every citizen an equal opportunity to enjoy the fruits of his ingenuity and toil, to have educational and health facilities of top quality, and to look with confidence to his future, with the same rights as his fellow American citizens.

You must not fail us at this hour of decision.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF JAIME B. FUSTER

Mr. Chairman, Members of the Senate Finance Committee: I want to bring to your attention a very vital issue that must be addressed by this Committee if the referendum process envisioned in S. 712 is to be meaningful. I refer to the question of the economics of the statehood option, more specifically, to the question of the effect that statehood would have upon the economy of Puerto Rico.

This is an issue that this Committee must address because otherwise it cannot properly consider the question that you will be exploring today about the potential cost to the U.S. Treasury of statehood for Puerto Rico. Any reasonable assessment of the Federal budgetary costs of statehood must address the fundamental question of what would happen to Puerto Rico's economy upon the advent of statehood. This is so because a very credible case can be made that statehood would so disrupt the island's economy that inevitably Federal transfer payments to the island would have to be substantially increased to avoid economic disaster. Reputable Puerto Rican sources claim that statehood will cause a total net loss of over 200,000 jobs in the island from both the public and private sectors. If this claim has any basis, it would mean that under statehood the current 15% unemployment rate of Puerto Rico would more than double, geometrically increasing local demand for Federal assistance.

This issue has not been examined at all by the various federal agencies or congressional committees studying the potential effect of Puerto Rican statehood upon the Federal budget. No attempt has been made to draw any connection between economic change under statehood and the need to increase Federal spending. Studies have been made about additional Federal expenditures that would be required under the statehood option, but all such studies have merely attempted to estimate how much the Federal costs would increase in giving Puerto Rico parity or equal footing with the rest of the 50 states regarding federal benefits. They have all assumed that there would be no other change in the island's economy. They all assume that all existing needs for nutrition assistance, health care, college loans and scholarships, unemployment benefits and so forth will remain the same under statehood.

Such assumptions may be grossly unwarranted. Puerto Rico's economy today is built around its exemption from Federal taxes, an exemption that would be precipitously ended by the advent of statehood. The elimination of Federal tax exemption would have at least three major effects upon the island's economy. First, it would deprive the local government of most of the funds it now has, largely diminishing its role as the main support of the Puerto Rican economy. Exemption from Federal taxes has permitted Puerto Rico to support a large public sector providing vital public services and employing more than a third of the work force. Financing for this huge public sector comes mainly from Puerto Rico income taxes which are higher than Federal income taxes and excise taxes which are higher than most state sales taxes. To superimpose Federal taxes upon them would cause the burden of taxation upon Puerto Rico's narrow tax base to be unbearably heavy or would force a massive reduction in public services and public employment. It is estimated that the removal of Federal tax exemption under statehood could deprive the local government of 60% of its current revenues with no new Federal expenditures to compensate for this particular loss, causing, therefore, the removal from the island economy of hundreds of millions of dollars in services, jobs and capital investments.

Second, the removal of Federal tax exemption would be a grave blow to the cornerstone of the private sector, Section 936 of the Internal Revenue Code. The Federal tax benefits of Section 936 have allowed Puerto Rico's own tax incentives to serve as a powerful inducement for manufacturing companies to build production facilities in Puerto Rico. About three fourths of all manufacturing employment in Puerto Rico is in 936 companies. Moreover, 936 deposits in Puerto Rican banks have allowed the financial sector to grow and thrive to unprecedented levels. Together manufacturing and banking and the indirect service jobs they create account for close to a third of the island's labor force. They also account for the largest share of Puerto Rico's domestic product. Here again, the elimination of Federal tax exemption will inevitably result in a sharp decline of the existing manufacturing and financial structure with the loss of thousands of jobs and the removal of hundreds of millions of dollars from the productive sector of the island's economy.

Finally, the removal of Federal tax exemption under statehood would be a severe blow to the construction industry in Puerto Rico. Both housing developments and the construction of hospitals, industrial plants, hotels and other infrastructure are made largely possible in Puerto Rico through financial instruments that depend on local and Federal tax exemption. Puerto Rican sourced GNMA mortgages, Puerto

Rican housing and industrial revenue bonds and other Puerto Rican government securities, commercial bank and S&L deposits, and other such instruments generate huge local private investments that make possible most of the construction and capital development that occurs in the island. Here again the loss of local tax autonomy which would accompany statehood would be a severe blow to the financing of construction in Puerto Rico, causing a serious decline in jobs in this sector and the removal of hundreds of millions of dollars from the island's economy.

It is important to note that these three major adverse effects of the removal of Federal tax exemption are separate and distinct from each other.

In other words, these are consequences that fall upon different sectors of the island economy. When one considers them *jointly;* that is, when one takes into account their cumulative or synergetic effect, as one must in an integrated economic model, it becomes obvious that it may be very foolish to estimate Federal Treasury costs of statehood for Puerto Rico without also examining the question of how the Puerto Rican economy is to survive without Federal tax exemption. The combined effect of the potential decline of all the major sectors of the Puerto Rican economy upon the advent of statehood makes this an essential issue to be studied by those in charge of gauging the Federal budgetary implications of Puerto Rican statehood.

Mr. Chairman and Members of the Committee, to conclude my testimony, let me briefly mention a second different reason why this Committee should address the issue I have raised with you. No legitimate decision on the future status of the island can be made by Puerto Ricans unless we have been well apprised beforehand as to the economic risks we might have to assume in order to attain statehood. As you know, under Commonwealth status Puerto Rico has experienced an impressive economic development. We have progressed from being a "stricken land" and the "poorhouse of the Caribbean" to becoming the people with the highest standards of living in all Latin America. Under the existing economic arrangements, in all but four of the 37 years of Commonwealth, the Puerto Rican economy has either matched or surpassed the growth rates of the United States economy. In fact, in 25 of those 37 years our growth has been markedly superior to that of the mainland, roughly double most of the time.

And yet, despite this remarkable pattern of growth, Puerto Rico's average per capita income is still only one third that of the mainland, unemployment is still around 15%, and 43% of family households depend on Federal aid to meet their nutritional needs. In the face of this stark reality, statehood leaders in Puerto Rico are telling us that the eventual elimination of the economic advantages of Commonwealth, as would happen under statehood, will not only not cause negative results in the island but that, to the contrary, economic growth will be far superior to what we have experienced during the last four decades. Statehood is portrayed as the panacea for the many complex and intractable social and economic problems that Puerto Rico has suffered for centuries. Puerto Ricans are being told that with statehood unemployment will nearly disappear, education and health care will be of the highest quality possible, our local roads will be like the best interstate highways, there will be no homeless, even crime will diminish.

We in Puerto Rico have a right to know whether or not the United States Congress shares these alluring expectations about the bonanza that allegedly will accompany statehood. In 1966 the congressionally created U.S.-Puerto Rico Status Commission, headed by Sen. Henry Jackson, after conducting the most encompassing study ever realized on this matter, concluded, that "unless an appropriate substitute for Puerto Rico's present economic arrangements can be provided, it is clear that statehood . . . would have severe and probably disastrous consequences . . . . It is not helpful to the people of Puerto Rico to claim that the economic question of statehood is not potentially a very serious one."

We in Puerto Rico have a right to know whether that assessment is still valid. And if it is, as many of us believe it is, then we have a right to know what precisely are the new arrangements that will substitute Commonwealth's strong economic advantages. We have a right to know what concretely will take the place of our existing tax incentives program which accounts for one of every three jobs in the island today. We have a right to know what concretely will take the place of Puerto Rico's fiscal autonomy which has allowed the strong centralized government of Puerto Rico to provide extensive health, education, housing and other vital public services to our large population of poor or low income citizens, services that no state government in the mainland can afford to offer at a comparable magnitude. We deserve to know what is your most considered judgment on this crucially vital matter. Mr. Chairman, the growth of the Puerto Rican community has been bogged down for too long because of the endless and barren status debate. We can get out of this quagmire if you lend us a hand. Make this referendum a really meaningful process by properly addressing this vital issue so that the people of Puerto Rico can truly make an intelligent choice.

PREPARED STATEMENT OF PAUL GEWIRTZ

Mr. Chairman and Members of the Committee: My name is Paul Gewirtz. I am a Professor of Law at the Yale Law School. I have taught at Yale since 1976, where my main teaching and writing has been in the field of Constitutional Law. Prior to teaching at Yale, I was a law clerk to Justice Thurgood Marshall at the Supreme Court of the United States, and I practiced law for several years here in Washington.

I am very pleased to have the opportunity to testify today on behalf of the Statehood Party of Puerto Rico (the New Progressive Party). I have been asked to address specifically whether there is any constitutional obstacle to the tax treatment of the new State of Puerto Rico as provided in S. 712. My answer is that there is no constitutional obstacle These tax provisions may raise complicated *policy* questions, but the Constitution gives Congress extremely broad leeway in making these policy judgments. My message, in brief, is that the Constitution leaves you an extremely free hand to do what you think makes the most policy sense regarding the tax treatment of Puerto Rico as it moves from its current status to statehood. If there are difficult issues facing Congress concerning these tax proposals, they are policy issues, not constitutional ones.

I. INTRODUCTION: ECONOMIC ADJUSTMENTS FOR NEW STATES

The tax provisions of S. 712 at issue here appear in Section 213 of the bill, the section that provides for a variety of economic adjustments for the new State of Puerto Rico. Their purpose is to facilitate Puerto Rico's transition from territory to State, and their legal status is inseparable from this purpose.

Since the earliest days of our country's history, all sorts of special economic aid and adjustments have been included as part of the state admissions process. For example, beginning with Ohio in 1802, Congress has typically given extensive tracts of Federal land to new States to assist them in financing their new responsibilities.[1] In the recent case of Alaska, an immensely valuable grant of 100,000,000 acres was made. Direct cash grants—such as the general purpose grant of $28,600,000 provided to Alaska over a five-year period—have been common as well.[2] Congress has also subsidized newly-admitted States through other means. Alaska once again provides an example: Under the Mineral Leasing Act, as amended by Alaska's Enabling Act, the State of Alaska receives 90% of the revenues earned through the leasing of Federal mineral lands located in the State, while all other States only receive 50% of comparable lease revenues. 30 U.S.C. § 191 (1982).

These general economic adjustments all seek to facilitate the transition from territory to State and to ensure that the new State gets off on a sound economic footing. Such assistance falls comfortably within a variety of different congressional powers, viewed singly and in combination. Congress' twin Article IV powers "to admit new States" and "to make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States"—as supplemented by the Necessary and Proper Clause—give Congress broad authority to facilitate the transition from territory to State. Congress' power to dispose of its "other Property" is an independent source of the authority to make land grants to States. *Alabama* v. *Texas*, 37 U.S. 272 (1953). And Congress' spending power gives Congress virtually unlimited leeway to expend public funds in ways that, in its judgment, will "provide for the . . . general welfare." Art. I. Sec. 8.[3] The particular type and amount of aid

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[1] Comptroller General, Experiences of Past Territories Can Assist Puerto Rico Status Deliberations (1980), p. 15.

[2] *Id.* at 14-18; L. Davila-Colon *et al.* Breakthrough From Colonialism: An Interdisciplinary Study of Statehood (1984), pp. 1153-54.

[3] Expenditures under the Spending Clause must be for the "general welfare," but "[i]t is for Congress to decide which expenditures will promote the general welfare." *Buckley* v. *Valeo*, 424 U.S. 1, 90 (1976). The Supreme Court "has declared that, in deciding whether the objective of a particular expenditure program is the national interest rather than merely the interest of the directly benefited locality, 'discretion belongs to Congress, unless the choice is clearly wrong, a display of arbitrary power [rather than] an exercise of judgment.' [quoting *Helvering* v. *Davis*, 301 U.S. 619, 640 (1937)] . . . Judgments concerning the generality of benefits conferred by Federal expenditures require determinations of fact that Congress is better equipped to make than

Continued

or adjustment has typically depended upon the circumstances surrounding a particular admission—including both the particular needs of the new State in question, and the resources available to the Congress at the time.

II. THE ISSUE: THE CONSTITUTIONALITY OF A TAX TRANSITION FOR PUERTO RICO

As part of the economic adjustments for the new State of Puerto Rico, S. 712 contains two tax provisions which are the main ones at issue here. First, Section 936 is phased out gradually, rather than abruptly terminated upon statehood. Second, there is a delay of two years in applying the personal income tax to the new State of Puerto Rico. The main reasons for these provisions are clear. Over the years, Congress has treated the territory of Puerto Rico uniquely for tax purposes, exempting it from the personal income tax under Section 933 and providing for the Section 936 tax credit. In light of this unique history, S. 712 does the reasonable thing: it provides for a transition period to a new tax regime, so that new taxes will be imposed in a gradual manner and sudden disruptions to the economy of the new State will be avoided. In addition, the transition period gives both the Federal Government and the Government of Puerto Rico time for needed administrative measures to implement the new tax regime. In light of Congress' broad powers to make economic adjustments when admitting new States, it would seem apparent that Congress could provide a tax transition for Puerto Rico that is justified by Puerto Rico's unique history and situation.

Nevertheless, Professor Laurence Tribe, who has been retained by the Commonwealth Party (PDP), objects that such transition provisions are unconstitutional. According to Professor Tribe, these provisions violate the Uniformity Clause of the Constitution. That is flatly wrong. As elaborated below, the constitutionality of tax transition features for Puerto Rico is overwhelmingly supported by the case law and by a broad range of legal experts. Indeed, when Professor Tribe made his arguments to the Senate Energy Committee, they were rebutted by various witnesses and written submissions, and were rejected by the Committee. The Committee Report states:

> Another issue of controversy is whether or not Section 213 is constitutional because it does not immediately and fully apply Federal taxes . . . and may thus be in violation of the uniformity clause of the constitution. The Committee disagrees with this view and believes Congress has substantial authority under the territorial and statehood clauses of the Constitution to provide for non-identical economic treatment under statehood if such treatment is reasonable, transitional, and necessary. The provisions of Section 213 are not only reasonable, but necessary in order to provide: Federal agencies the time needed to implement certain new taxes and social programs in Puerto Rico, Puerto Rico with the time needed to modify local tax and social program laws, and to avoid extremely serious disruptions to the economy of Puerto Rico during the transition from commonwealth status to statehood.[4]

A. Congress May Frame Special Tax Treatment in Geographic Terms

The alleged constitutional problem with the tax provisions in Section 213 of S. 712 is the Uniformity Clause of the Constitution (Art. I., Sec. 8, § 1), which provides that "all Duties, Imposts and Excises shall be uniform throughout the United States." Professor Tribe at times suggests that the Uniformity Clause generally prohibits geographically-defined taxes and for that reason would prohibit special transitional tax treatment for Puerto Rico after it became a State. But in fact that is not the law; that is not what the Uniformity Clause means. Even assuming that the Uniformity Clause applies to the income tax—a question never squarely decided by the Supreme Court[5]—it is crystal clear that the requirement of uniformity does *not* bar

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the Supreme Court. Given such judicial deference, the generality limit on congressional spending is more apparent than real." L. Tribe, American Constitutional Law (2d ed. 1988), p. 322-23. Clearly Congress could plausibly make the judgment that spending targeted to the new State of Puerto Rico, to facilitate its transition into the Union and to enable it to function more effectively in the American economy, was in the general national interest.

[4] Puerto Rico Status Referendum Act, H.R. Rep. No. 120, 101st Cong., 1st Sess. 39 (1989).

[5] Whereas the first clause of Art. I, Sec. 8, § 1 refers to "Taxes, Duties, Imposts and Excises," the Uniformity Clause applies only to "Duties, Imposts and Excises," pointedly omitting "Taxes" from its reach. This has led the Court to distinguish between taxes that are subject to the uniformity rule (typically referred to as "indirect" taxes) and "direct" taxes. After the 16th Amendment, the status of various types of income taxes confounds these categories. *See, e.g., United States* v. *Ptasynski*, 462 U.S. 74 (1983) *Brushaber* v. *Union Pacific Railway Co.*, 240 U.S. 1 (1915).

geographically-defined tax treatment. And the case for Congress' geographically-defined tax treatment for the State of Puerto Rico is especially strong, since the special treatment here is part of the admission of a new State with a unique tax history and involves the transitional phasing out of the existing special tax treatment under Puerto Rico's territorial status.

(1) JUDICIAL PRECEDENT: SUPREME COURT CASES

No Supreme Court case has *ever* relied on the Uniformity Clause to invalidate a congressional tax provision.[6] The most recent major case squarely on point is the Supreme Court's 1983 decision in *United States* v. *Ptasynski*, 462 U.S. 74 (1983), in which the Court upheld the constitutionality of an exemption to the Crude Oil Windfall Profit Tax Act of 1980. The Act excluded "exempt Alaskan oil" from the tax. In a *unanimous* opinion for the Court, Justice Powell rejected the claim that this state-specific exemption was prohibited by the Uniformity Clause. "The Uniformity Clause gives Congress wide latitude in deciding what to tax," *id.* at 85, and "'does not deny Congress the power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems.'" *Id.* at 84-85 (quoting Rail *Reorganization Act Cases*, 419 U.S. 102, 161 (1974)).

Thus, the Uniformity Clause permits geographically-based tax treatment "to deal with a geographically isolated problem." What the Clause forbids is "geographic discrimination," which does not address a real geographic difference and is therefore unconstitutional. As Justice Powell noted, the purpose of the Uniformity Clause is to prevent "oppressive inequalities" through which a combination of States might set differential tax rates in a way that would harm the economic interests of rival States. *Id.* at 81. To avoid running afoul of this purpose, *Ptasynski* requires only that a geographically-specific tax be "based on neutral factors"—meaning that the justification for a geographically-specific tax must be an actual problem that corresponds to the geographic area singled out, not simply geographic discrimination for its own sake.[7] And in *Ptasynski*, the Supreme Court readily deferred to Congress' finding of such factors: that Alaska's "fragile ecology, harsh environment, and remote location" created a geographically-specific problem, and made the "exempt Alaskan oil" a "unique class of oil" meriting special tax treatment. Id. at 85. The Court concluded the opinion by underscoring its attitude of deference to Congress in applying the Uniformity Clause to congressional tax policy: "Where, as here, Congress has exercised its considered judgment with respect to an enormously complex problem, we are reluctant to disturb its determination." Id. at 86.

(2) CONGRESSIONAL PRECEDENT: THE HAWAII/ALASKA TRANSPORTATION TAX EXEMPTION

One need look no further than the Enabling Act concerning the admission of the two most recent states, Alaska and Hawaii, to see another highly relevant precedent for continuing certain special tax treatment that Puerto Rico currently has—a powerful *congressional* precedent if not a judicial one. The Enabling Act continued indefinitely the exemption from the Transportation Tax Law which those two States had enjoyed as territories, and this exemption remains in force today. Travel between two of the forty-eight continental States is fully taxed, while travel between one of the forty-eight States and Alaska or Hawaii is mostly tax-exempt. 26 U.S.C. § 4261 *et seq.* (1982). This state-specific treatment, like the special treatment of Alaska upheld in Ptasynski, is justified because Congress determined that there is a

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[6] Note, The Uniformity Clause, 51 U. Chi. L. Rev. 1193, 1193 (1984).

[7] In his submissions to the Senate Energy Committee, Professor Tribe seemed to suggest that the "based on neutral factors" language in *Ptasynski* means that a tax may not be geographically-specific. That is a clear misreading. The "neutral factors" are what must *underlie* a geographically specific tax; but Congress is permitted to write tax laws in a geographically-specific (and geographically-selective) way, as the statute in *Ptasynski* demonstrates.

In a related effort to blunt the devastating effect of *Ptasynski* on his constitutional claim, Professor Tribe also attempts to argue that the tax statute in *Ptasynski* was really not state specific. Thus, he tries to make much of the fact (noted in the Supreme Court's opinion) that the exemption in *Ptasynski* did not cover all of Alaska's oil, but only some Alaska oil, and that the exemption also included oil in certain offshore territorial waters beyond the boundary of any State. But neither fact detracts in the slightest from the reality that the exemption was drawn on explicitly geographic lines and that Alaska was the only state covered by the exemption. And neither fact led the Supreme Court to treat the exemption as anything other than a geographically-specific tax provision—and to uphold it on that basis.

"geographically isolated problem" specifically, the "handicap which [Alaska and Hawaii] suffer because of their distance from the mainland of the United States."[8]

B. Phasing Out Puerto Rico's Territorial Tax Treatment as Part of its Admission as a New State is Permissible Geographically-based Tax Treatment

Just as Congress had an ample basis for concluding that Alaska's unique problems justified special tax treatment under the Windfall Profit Tax, and that Alaska and Hawaii's unique problems justified special tax treatment under the Transportation Tax, Congress surely has an ample basis for concluding that temporary special tax treatment of Puerto Rico would address a "geographically isolated problem"—namely, the fact that Puerto Rico's economy has developed around a long history of geographically-special tax treatment. As in *Ptasynski*, if Congress were to "exercise its considered judgment with respect to [the] enormously complex problem" here and decide that special tax treatment were warranted, the courts would surely not "disturb its determination." *Ptasynski*, at 86.

Both the Alaska exemption from the Windfall Profits Tax and the Hawaii/Alaska exemption from the Transportation Tax are examples of *open-ended* special tax treatment based on geography. The special tax treatment provided in S. 712 is, if anything, easier to justify, because Congress is admitting a new State and the special tax treatment is only *temporary and transitional*, arising as a part of the admission of a new State. As noted above, Congress has long found it necessary to aid a new State in various ways during an initial period—and this has included adjusting the application of certain Federal laws to it for some period.[9] There is no reason why Congress may not also temporarily adjust the tax laws and grant temporary special tax treatment to facilitate the transition from (tax-exempt) territory to (tax-eligible) State. The rationale for such a tax transition period is to avoid sudden disruptions to the economy of the new State and to permit the orderly administrative implementation of a new tax regime. The Senate Energy Committee found that Puerto Rico's unique tax history warranted this special transitional tax treatment and that this treatment was "not only reasonable, but necessary." (See Energy Committee Report, quoted at pp. 5-6 above.) The Uniformity Clause does not bar this kind of temporary geographically-defined tax treatment because, in *Ptasynski's* terms, Congress would have identified a temporary "geographically isolated problem."

The point here is not that Article IV somehow gives Congress the power to create an "exception" to the requirements of the Uniformity Clause (which is how Professor Tribe has characterized our argument). The point is that the context of admitting this new state creates the particular justification for the geographically-based tax treatment here. The territory of Puerto Rico has long operated under a unique Federal tax regime, and it is precisely Puerto Rico's admission as a State and its movement to a new tax regime that creates the unique problem of "getting from here to there"—a problem that no other State in the Union has.[10]

Similarly, in emphasizing the temporary transitional duality of the special tax treatment of Puerto Rico, our point is not that violations of the Uniformity Clause are somehow acceptable so long as they are temporary. The temporary nature of the special tax treatment here is part of what establishes that it does not violate the Uniformity Clause at all. The temporariness demonstrates that the geographically-specific tax treatment here is no broader than its justification. The geographically isolated problem that needs to be addressed is the economic and administrative effects caused by the changeover from an old tax regime (as a territory) to a new one (as a State) The temporary tax transition provided by S. 712 is tailored to the geographically-based problem identified, and is no broader than that.

Since it addresses a "geographically isolated problem," S. 712 does not offend the underlying purpose of the Uniformity Clause, which is to prevent a faction of dominant States from imposing "oppressive inequalities" on other States. *Ptasynski*, *supra*, at 82. Indeed, Congress is not singling out a State or States for any burden at all. Responding to a new State's unique problem, it is maintaining the status quo for a period time: simply allowing its prior special tax treatment to continue for a while and then be phased out gradually. All of this overwhelmingly demonstrates that the geographically-based tax provisions here are a far cry from the kind of geographic "discrimination" that the Uniformity Clause would condemn.

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[8] See 102 Cong. Rec. 5832 (1956) (memorandum of bill's sponsor), endorsed in S. Rep. No. 331, 86th Cong., 1st Sess., U.S. Code Cong. & Ad. News 1675, 1689 (1956).

[9] *E.g.*, *Comptroller General*, *supra* note 1, pp. 27-28.

[10] Thus, it is constitutionally irrelevant that in Ptasynski the special tax treatment was for only some Alaska oil, but that here the special tax treatment applies throughout the State of Puerto Rico. In *Ptasynski*, the geographically defined problem was not state-wide; here it is, because all of Puerto Rico has been operating under the old tax regime involving Section 936 and 933.

Coyle v. *Smith*, 221 U.S. 559 (1911), on which Professor Tribe puts such great weight, does not help his case at all. He wrongly interprets *Coyle* as requiring that a newly-admitted State be treated exactly the same as existing States. If this were true, Congress' longstanding practice of singling out new States for land grants and other economic aid would be unconstitutional. But *Coyle* is not a general guarantee of equal treatment. *Coyle* simply prohibits Congress from making substantive intrusions on the sovereignty of a newly-admitted State. The guarantee of "equal footing" means that a new State must have all the substantive rights of an existing State.[11] In *Coyle* itself, Congress interfered with the State's right to chose the location of its own capital. And every item in Professor Tribe's "parade of horribles" involves Congress making a substantive intrusion on a constitutional right: suspending the republican form of government guarantee; exempting a new State from the Takings Clause; overriding the jury trial provision. Obviously such intrusions are unconstitutional, whether they are temporary or permanent. But the temporary tax provision for Puerto Rico is nothing like these, nor is it like the provision struck down in *Coyle*. A transitional tax exemption would not violate the substantive rights of the State of Puerto Rico, of its citizens, or of anyone else.

None of this is to say that Congress is compelled to provide special tax treatment to the new State or to use the current approach of S. 712. But the point here is that the *Constitution* does not stand in Congress' way, in spite of what some have suggested. The issues before you are issues of policy alone. A policy choice might lead Congress to frame tax treatment in general subject terms that are favorable to Puerto Rico;[12] to collect all taxes from Puerto Rico immediately upon statehood, but directly return tax revenues from the U.S. Treasury to the Puerto Rican Treasury;[13] or to cushion the effect of the application of new taxes with direct economic assistance to Puerto Rico. But if Congress concludes that Puerto Rico's needs, given the history of its tax treatment, justify temporary special tax rules after it becomes a State, nothing in the Constitution bars Congress from making the appropriate adjustments. Congress, in brief, has extremely broad constitutional leeway to structure appropriate tax policies for the new State of Puerto Rico.

III. CONCLUSION

Professor Tribe stands alone in his rigid reading of the Uniformity Clause. His conclusions are at odds not only with my own, but with the conclusions reached by a broad range of scholars and lawyers. These other views are worth summarizing to underscore just how isolated Professor Tribe is on this issue:

(1) Nineteen years ago, the late Professor Alexander Bickel of the Yale Law School, surely one of this century's greatest constitutional scholars, wrote a legal

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[11] The "equal footing" doctrine "has long been held to refer to *political* rights and to sovereignty," and not to include "economic stature or standing." *United States* v. *Texas*, 339 U.S. 707, 717 (1949) (emphasis supplied). It prohibits Congress from admitting a new State with less "political standing and sovereignty" than the other States, *id.*, and in no way bars Congress from giving the new State economic assistance appropriate to its situation or "ced[ing] property to one State without corresponding cessions to all States." *Alabama* v. *Texas*, 347 U.S. at 275 (Reed, J., concurring).

[12] The Uniformity Clause is satisfied whenever the tax "operates with the same force and effect in every place where the subject of it is found" (*Head Money Cases*, 112 U. S. 580, 594 (1884)). Thus, if Congress wishes to avoid defining a tax or tax exemption in explicitly geographical terms (even though *Ptasynski* perrmits it) Congress may define the tax or tax exemption in terms of a "subject" which has theoretical application throughout the United States but which is closely sculpted to suit special Puerto Rican circumstances. Congress, for example, could define a Federal tax exemption in terms of the presence or absence of a particular feature of local law, such as the presence of a local tax exemption of a particular character. *See, e.g.*, *Fernandez* v. *Wiener*, 326 U.S. 340, 359-60 (1945); Internal Revenue Code § 512(b) (15). The choice between using this "subject matter" approach and using an explicitly geographic approach is fundamentally a matter of policy and practicality, not constitutional law.

[13] This is now done with Federal excise taxes on rum, and S. 712 continues that procedure. S. 712 also proposes a similar procedure for Federal personal income taxes until 1994. This approach poses no Uniformity Clause issue at all since the tax itself "is assessed equally upon all [applicable taxpayers] wherever they are," without any geographic distinction. United *States* v. *Singer*, 82 U.S. (15 Wall.) 111, 121 (1872). The "give-back" of taxes to the State, like cash grants, land grants, and other forms of economic assistance, is not restricted by the Uniformity Clause. As noted above (see pp. 3-4), Congress' power to single out a State for special economic assistance is essentially plenary. "It is for Congress to decide which expenditures will promote the general welfare." *Buckley* v. *Valeo*, 424 U.S. 1, 90 (1976).

opinion on this question and agreed that "temporary, transitional adjustments in the application in Puerto Rico of United States internal revenue laws could constitutionally be made" (page 1). As he explained:

> In admitting a new state, Congress may find it necessary, and has historically most often found it necessary, to aid the new state in various ways, and to ease or adjust the application of Federal laws to it, and the operation of Federal institutions within it, during an initial period. There is no real reason why the internal revenue laws may not be temporarily so adjusted, as by granting temporary preferential tax treatment. The history of the prior relationship between a territory and the United States would be a decisive consideration in validating a temporary preferential treatment which can be explained as reasonable in light of that prior history, in the sense that it substitutes a gradual transition for a sudden and possibly dislocating change. (pages 5-6)

The full text of Professor Bickel's opinion appears as Attachment 1 to my testimony.

(2) In the same year, one of Harvard Law School's most distinguished constitutional scholars, Professor Arthur Sutherland, also wrote an opinion letter agreeing with that position. The full text of his opinion letter appears as Attachment 2 to my testimony.

(3) More recently, the Senate Energy Committee, which heard from Professor Tribe about this issue on at least two separate occasions, concluded that transitional tax treatment of Puerto Rico is constitutional. (The Committee Report is quoted at pages above. I am also including as Attachment 3 to this testimony a transcript of the exchange I had with Senator Johnston, Chairman of the Committee, during the question and answer period following my own testimony before that Committee.[14])

(4) The Department of Justice, in its testimony before the Energy Committee, agreed that transitional tax treatment for the new state of Puerto Rico would be constitutional.

(5) The Library of Congress' Congressional Research Service has prepared a memorandum agreeing with our position.

(6) The Supreme Court's decision in the *Ptasynski* case, while obviously not addressing the specific question here, was *unanimous* in reaffirming an extremely deferential approach to Congress in evaluating geographically-specific tax statutes under the Uniformity Clause—an approach altogether at odds with the one Professor Tribe takes.

(7) And finally, it is worth emphasizing that Supreme Court decision in the entire history of our country has ever struck down a congressional statute on Uniformity Clause grounds.

Obviously, this Committee must make its own judgment about the tax provisions of S. 712. But I urge you to disregard Professor Tribe's lonely objections to the constitutionality of those provisions. He stands alone, and he is simply wrong.

Thank you, Mr. Chairman and Members of the Committee, for this opportunity to appear before you.

Attachments:

[ATTACHMENT 1: BICKEL OPINION]

MEMORANDUM FOR WALLACE GONZALEZ-OLIVER, ESQUIRE

You have asked me to review a paper dealing with the applicability of United States internal revenue laws to Puerto Rico, should Puerto Rico become a state of the Union; and you have asked that I render you an opinion, concentrating particularly on the constitutional issues.

In forming my opinion, I have relied essentially on the authorities and the information collected and discussed in your excellent paper. I have undertaken only the most limited sort of independent investigation of my own.

Stated generally, my opinion is that Puerto Rico could not, as a state, constitutionally receive an indefinite exemption from United States internal revenue laws, or benefit for an indefinite period from a modified application in Puerto Rico of those laws. I believe, however, that no constitutional obstacle stands in the way of writing into tax statutes exemptions, deductions and credits which have theoretical, and indeed possible actual, application throughout the United States, but which are tailored closely to suit special Puerto Rican interests. My opinion is also that temporary, transitional adjustments in the application in Puerto Rico of United States internal revenue laws could constitutionally be made. I believe, finally, that both categorical and unrestricted grants from the Federal Government can, without encountering any constitutional difficulties, achieve for a quite extended period of time all or nearly all that exemption from the application of internal revenue laws would accomplish.

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[14] *Political Status of Puerto Rico: Hearing Before the Senate Committee on Energy and Natural Resources, Part I*, 101st Cong., 1st Sess. 353 *et seq.* (1989).

While I agree that the question whether an income tax is subject to the requirement of geographic uniformity is an open one, in the sense of never having been squarely decided, I think the reasoning of *Brushaber* v. *Union Pacific Ry. Co.*, 240 U.S. 1 (1915), would prove persuasive to Congress and the Supreme Court.

It is perfectly true that the Constitution on its face leaves room for some doubt. The subject of taxation is first mentioned in Article I, Section 2, where we are told that "direct Taxes," like Representatives in the Federal House, are to be "apportioned among the several States." At this stage, no power to tax has yet been granted by the constitutional text, and this section does not constitute the grant. It is concerned, rather, with the apportionment of Representatives, and with the highly vexing problem of how to count the slave population, and mentions direct taxes only by the way, because they also are to be apportioned, and the draftsman wanted as few occasions as possible for the discussion of the distasteful matter of counting slaves, and wished to dispose of it in all its aspects once and for all. The express grant of the power to "lay and collect Taxes Duties Imposts and Excises" then comes in Section 8 of Article I, and the requirement of uniformity does apply only to "Duties, Imposts and Excises." We are then also told separately in Section 9 of Article I—separately, that is, from the subject of Representatives in Congress—that direct taxes are to be apportioned. Thus unless we conclude from the fist reference to "direct Taxes" that the Framers understood the words, "tax or taxes," in strict usage, to be synonymous with "*direct* tax or taxes," Sections 2, 8, and 9 of Article I, taken together, are open to the interpretation that Congress could lay direct taxes, which had to be apportioned; duties, imposts and excises, which had to be uniform; and taxes that were neither direct, nor duties, imposts or excises, and which needed neither to be apportioned, nor to be uniform.

But it can well be argued that the terms "tax" and "direct tax" *were* used as synonyms. The word "tax" appears twice more in Section 9, both times in the phrase "tax or duty," and in both instances the tax that was being contradistinguished from a duty would, I think have been viewed as a direct one, because falling on property. (See *Brushaber* v. *Union Pacific Ry. Co., supra*, 240 U.S. at 19.) In any event, the reasoning of the *Brushaber* case cuts across the textual doubts, such as they may be, and comes to rest on the proposition that, aside from the special problem of apportioning direct taxes, the Constitution intended to prevent Congress from using its taxing power to favor one geographical region of the country over another. That makes sense, and it suggests that indirect, and therefore unapportioned, taxes must be geographically uniform, whatever they may be called. That is the substance of the matter, rising above nomenclature.

Of course, as *Brushaber* itself held, Congress has wide latitude in electing to tax or not to tax an activity or interest. Congress may also treat different activities and interests differently, and quite arbitrarily so. Covertly, then, if not overtly, Federal taxation may fall differently on various regions, in accordance with the activities and interests that characterize a region. The requirement of geographic uniformity does have some practical consequences; it does operate as something of a constraint. Nevertheless, geographic uniformity may be seen in some measure as more a symbolic than a practical value. Yet I think it would still be viewed as a symbolic value of considerable importance to the health and the morale of the body politic in a federated republic. It would, I think, be considered particularly important in the case of so pervasive aid fundamental a system of taxation as the income tax, so that even if it were admitted that some indirect taxes need not be uniform, I would doubt that the income tax would be classified among them. I realize that the precedent of the exemption in favor of Hawaii and Alaska from the transportation tax (*Paper*, pp. 149 *et seq.*) is to the contrary, but I believe that exemption might be held unconstitutional if it could be brought into litigation, and it does not involve, of course; anything of the pervasive importance of the income tax.

As I have indicated, and as your paper thoroughly demonstrates, *geographical* uniformity is all that is required. Congress may certainly condition a tax or an exemption or deduction upon selected features of local law, which states may voluntarily adopt or not, as they choose. (Cf. *Florida* v. *Mellon*, 273 U.S. 12 (1927).) I see no reason why Congress may not do the same thing, in a sense, retroactively; that is, condition a tax or an exemption on the prior existence, as of a date certain, of a given feature of local law, so that the tax would not fall, or the exemption would not apply, in a jurisdiction which on that date did not have that given feature in its law. Thus, it would seem to me, Congress could exempt from the payment of certain Federal taxes corporations doing business in a State in which, for a given period of time, or on a date certain, such corporations were by the operation of local law (state or territorial) exempt from the payment of local taxes of a certain description.

Even the requirement of geographical uniformity may yield at the point, itself extending over a reasonable transitional time-span, at which the requirement is intersected by the power of Congress, under Article IV, Section 3 of the Constitution, to admit "New States . . . into this Union." In admitting a new State, Congress may find it necessary, and has historically most often found it necessary, to aid the new State in various ways, and to ease or adjust the application of Federal laws to it, and the operation of Federal institutions within it, during an initial period. There is no real reason why the application of internal revenue laws may not be temporarily so adjusted, as by granting temporary preferential tax treatment. The history of the prior relationship between a territory and the United States would be a decisive consideration in validating a temporary preferential treatment which can be explained as reasonable in light of that prior history, in the sense that it substitutes a gradual transition for a sudden and possibly dislocating change.

A new state must be admitted on a footing of equality with existing states. As held in *Coyle* v. *Oklahoma*, 221 U.S. 559, 567 (1911): "The power is to admit 'new States into *this* Union.' 'This Union' was and is a union of States, equal in power, dignity and authority, each competent to exert that residuum of sovereignty not delegated to the United States by the Constitution itself." The equality that is required is political. And the emphasis is on a prohibition against detracting from the sovereign power of a state, not against conferring benefits, certainly not against transitional benefits. Nor is there a prohibition against setting the selfexecuting terms of admission. In practice, Congress has at times gone farther (see *Paper*, p. 82), and I believe some of these farther steps that Congress has seen fit to take would have been declared unconstitutional, had it been possible to frame a proper litigation. But extending land or money grants to a new state, on a lump sum or annual basis, with or without conditions that could also be attached to grants made to any other state, seems to me unquestionably constitutional. Nor do I see how a transitional exemption from application, in whole or in part, of internal revenue laws—a form of benefit—could be deemed to violate the doctrine of the political equality of sovereign states. So the power to admit new states under Article IV, Section 3 may enable Congress to depart during a transitional period from the requirement of geographical uniformity in taxation, and nothing in the requirement that new states be admitted in a status of equality with the old would present any obstacle to the enactment of special transitional tax arrangements.

The issues I have been discussing are constitutional issues, and would be so treated by Congress in light of all—few as they may be—relevant pronouncements of the Supreme Court. Whether, however, if Congress granted a temporary or even an indefinite exemption to a new state of Puerto Rico from application of the Internal Revenue Code, or if it tailored special tax exemptions to the needs of Puerto Rico, or if it made novel and unprecedented block grants to Puerto Rico on a continuous annual basis—whether, if Congress did any or all of these things, the constitutionality of its actions could ever be litigated to a decision in the Supreme Court is quite another question. The conclusion that Congress reached on the constitutionality of such measures might very well remain the final one, and never be subject to judicial review. The reason is that grave, quite possibly insoluble, problems of standing would face a taxpayer or a state which wished to challenge the validity of grants or exemptions applicable to Puerto Rico. A taxpayer could not show that he stood to gain anything from a lawsuit challenging an exemption granted to another taxpayer. Nor can a taxpayer challenge a grant-in-aid on other than First Amendment grounds, which are unlikely to be applicable here, or at least unlikely to be generally applicable. (Cf. *Flast* v. *Cohen*.) The interest of a state, with respect to both tax-exemptions and grants, has I believe been clearly held to be non-justiciable.

(See *Florida* v. *Mellon, supra; Alabama* v. *Texas*, 347 U.S. 272 (1954.) In different circumstances, standing was assumed in a case coming from a state court in *Coyle* v. *Oklahoma, supra*, but on a basis that could not withstand challenge and analysis.

ALEXANDER M. BICKEL.

[ATTACHMENT 2: SUTHERLAND OPINION]

LAW SCHOOL OF HARVARD UNIVERSITY,
July 8, 1970.

Wallace Gonzalez, Esq.
P.O. Box 11,367
Santurce, PR

Dear Mr. Gonzalez: A number of weeks ago you asked me if I would give some study and thought to a question of constitutional law concerning the tax status of Puerto Rico, if that Commonwealth were to become a State. Subsequently, you sent me a lengthy study of the various legal questions involved in granting tax preferences to a new State of Puerto Rico. I have examined the study, done some outside reading, and now write this letter as a report of my conclusions.

Puerto Rico, having been duly authorized by Act of Congress, in 1919 repealed the Federal income tax law applicable within Puerto Rico and enacted a similar tax statute with rates comparable to those of the Federal Internal Revenue Code. The Puerto Rican income tax proceeds go to the government of that Commonwealth. If on the moment she attains statehood the Federal income tax law takes effect in Puerto Rico at the same rates which apply to the other States, her economy will be very hard hit.

Could the Congress constitutionally provide by statute for a transitional period of a few years during which the tax powers of the new State would by stages come to be taxed at the same rates as those in the older States? In my opinion this would be a constitutionally valid arrangement. Admission of new States occurs under Article IV, Section 3, which reads:

> New States may be admitted by the Congress into this Union; but no new State shall be formed or erected within the Jurisdiction of any other State; nor any State be formed by the Junction of two or more States, or parts of States, without the Consent of the Legislatures of the States concerned as well as of the Congress.
>
> The Congress shall have power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; and nothing in this Constitution shall be so construed as to Prejudice any Claims of the United States, or of any particular States.

This provision neither expressly authorizes nor denies to the United States the constitutional power to confer on a new State, at the moment of admission, some temporary transitional advantages not available to other States.

Three provisions of Article 1 and the Sixteenth Amendment contain language which may have some relevance.

> Article 1, Section 2: "Representatives and direct Taxes shall be apportioned among the several States which may he included within this Union, according to their respective Numbers."
>
> Article 1, Section 8, Clause 1: "The Congress shall have Power To lay and Collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises Mall be uniform throughout the United States."
>
> Article 1, Section 9, Clause 4: "No capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."
>
> Sixteenth Amendment: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

There is no decision of the Supreme Court directly in point, but general principles of constitutional construction, and a considerable body of congressional precedent, suggest that the "necessary and proper" clause of the Constitution, Act I, § 8, last clause, would empower the Congress to make the required transitional provisions for Puerto Rico.

The Constitution is not explicit in all the details of its grants of power. Its draftsmen must have intended to create a workable government, and when they empowered the Congress to admit new States they must have intended that the Congress be empowered to make sensible detailed arrangements for that admission. "We must never forget that it is a constitution we are expounding" wrote John Marshall in *McCulloch* v. *Maryland*, 4 Wheaton 316 (1819). The provision that "all Duties, Imposts and Excises shall be uniform throughout the United States" was not intended to put at a disadvantage a State in the process of admission. The requirement for uniformity was designed to inhibit a group of populous States from levying taxes in such a way as to damage States less heavily represented in the Congress. The gradual rise in the federal. tax rate applicable to Puerto Rico does not offend that purpose.

In the absence of Supreme Court precedent, congressional precedent properly has much persuasive force in constitutional questions. No one of these four clauses mentions the process of admission of new States nor does the admissions clause, Article IV, § 3 mention tax arrangements. In governing Puerto Rico the Congress has heretofore consented that she withdraw from the scope of the Internal Revenue Code, and the constitutionality of this action of the Congress is unchallenged. Assuming that the Congress decides to admit Puerto Rico at once, is there any constitutional barrier preventing the process of undoing the tax advantages Puerto Rico now enjoys, being made gradual, extending several years into the new period of Statehood?

The Congress in Section 22(b) of the Alaska Omnibus Act, Pub. L. 86-70, 73 Stat. 141, June 25, 1959, and in Section 18(A)(1) of the Hawaii Omnibus Act, Pub. L. 86-624, 74 Stat. 411, July 12, 1960, provided that for these two distant States, a partial exemption from an otherwise uniform application of a Federal, excise tax on air, fares, which had been granted to them as territories, would continue into Statehood. Every Congressman and Senator must take an oath to support the Constitution (Article VI); they must have considered that they recognized the unusual geographical position of the two new States and deviated from tax uniformity in their favor.

The Congress makes non-uniform grants to States, examples occur in Alaska and Hawaii. Congress could grant back to Puerto Rico after Statehood the revenues the Federal Government would derive from an application of the Internal Revenue Code in Puerto Rico. No constitutional mandate would require that such a grant be geographically uniform. The transitional period of gradual increase in Federal Tax Rates would have the same effect as a series of declining grants.

The constitutionality of the tax exemption during Puerto Rico's territorial phase appears reasonably clear. In a 1962 opinion the United States Court of Appeals for the Ninth Circuit used language suggesting the possibility of a penumbral period after Statehood begins during which transitional arrangements are proper.

> Traditionally, the concept has been that territorialism ends the minute statehood begins, but there are loose ends. New courthouses or equivalent facilities must be made ready. So we see no particular present day objection to transition provisions to operate within a limited time with vestiges of territorialism.
>
> *Mahlum* v. *Carlson* 304 F2d 285, 289 (9C, 1962). The length of the interim period in Puerto Rico would be for congressional discretion in the first instance. If there were to be a grave abuse of that discretion, and if a litigant had standing to challenge it, a Federal Court might review the propriety of the duration. See *Chastleton Corporation* v. *Sinclair* 264 U.S. 543 (1924).

If the Constitution did not require that an income tax be uniform, an alternative ground would obviously uphold the interim arrangements. An argument can be made that a tax on income, other than income derived from tangible real and personal property, is a third sort of tax neither "direct" under the requirement of apportionment, nor a "duty, impost, or excise" which must be uniform throughout the United States. If that were so the interim concessions to Puerto Rico would raise no other question However if the Supreme Court were to pass on this matter, I doubt that it would so hold. The opinion of the Court on the rehearing in *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895) struck down the tax on those sources of income not derived from real and personal property. It did so on the ground that the Congress would not be deemed to have intended such a minor part of the total tax to stand without the tax on incomes derived from real and personal property. The Chief Justice introduced his discussion of the topic by the following paragraph:

> We have considered the Act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments, in view of the instances in which taxation on business, privileges, or employments, has assumed the guise of an excise tax and been sustained as such.

If the validity of an interim scaledown of income tax in Puerto Rico could be tested in court, and if the case turned entirely on an argument that an income tax need not be uniform in any event, there would be a very substantial chance that the Supreme Court would hold that the tax must be uniform. The policy behind the uniformity requirement of Article I, § 8, Clause 1 applies to income taxes.

On the other hand the policy of reasonable adjustments in admission of new States tends to uphold the transitional provision.

This letter has not dealt with the question of a litigant's standing to raise the question of interim reduced income taxation for Puerto Rico. *Flast* v. *Cohen* 392 U.S. 83 (1868) held that a Federal taxpayer had standing to raise the constitutionality of Federal expenditures which violated the limitations imposed by the First Amendment. Mr. Chief Justice Warren, writing the Court's opinion, did suggest that a taxpayer might attack "a breach by Congress of the specific constitutional limitations imposed upon an exercise of the taxing and spending power." (392 U.S. 105). There is thus a substantial possibility that a Court test would be possible. And in any event "standing" is not a necessity in raising a constitutional question in the Congress. There the sturdy good sense of the gradual adjustment plan and the precedents in Alaska and Hawaii would have great weight.

If any matter in this letter seems to you unclearly expressed, I shall be pleased to attempt a clarification.

Sincerely yours,

ARTHUR E. SUTHERLAND.

The CHAIRMAN. Professor Gewirtz, I think your statement is more than convincing on most issues. I have a question really only about 936. I think there is no doubt at all that we can give grants and aids and help to Puerto Rico and can accomplish whatever it is in a number of different ways.

My question really is whether or not there is ambiguity left with respect to this issue on the uniformity clause and section 936.

I have the Ptasynski case, and it is very clear there that they say a tax is uniform when it operates on the same force and effect in every place where the subject of it is found. And they go on to say that sometimes there are geographical differences which the Congress may take into consideration.

Now, the subject of the tax in the Ptasynski case was oil, and the oil was different in Alaska than here because there it was discovered in a hostile environment and had to be transported over an expensive pipeline.

The subject of the tax in 936 is corporate transactions. Those corporate transactions may not be different. What is different with respect to 936 is the need of the island.

The Court goes in Ptasynski to talk about when the Congress frames a distinction in geographic terms, although the Congress has wide latitude, that where the Congress does choose to frame a tax in geographic terms, we will examine the classification closely to see if there is actual geographic discrimination.

Now, doesn't that suggest that perhaps there is a difference between the incidence of the tax? In other words, if you can define the thing taxed in different terms, you have wide latitude, but where you simply want to discriminate geographically in order to give money to one state over the other, unless you can identify a difference in the thing taxed, the incidence of the tax, doesn't that suggest some ambiguity here about the reach of those decisions?

Professor GEWIRTZ. I see the argument, but I think it is not right.

The thing that was taxed in Ptasynski was the oil. Oil is oil. What was different was the surrounding context, the geographic problems in the surrounding context. And so too in this situation. It may be that the corporate transactions are the same, but the thing that Congress could I think easily determine in its judgment is that the context was different.

The CHAIRMAN. Suppose, let's say for example, that I was able to talk the Congress into saying that income tax rates shall be lower in my State of Louisiana because unemployment is high and just say the income tax shall be 28 percent in the rest of the country and 15 percent in Louisiana. Would that be permitted under Ptasynski?

Professor GEWIRTZ. Well, I think we would need to know more. I think your example suggests that it is not very plausible that that would happen because it is not very plausible that people in Congress would conclude that there is something really unique about Louisiana for these purposes. But when it comes to something like 936, I think a lot of Members of Congress would conclude that there is something very different about Puerto Rico's history with regard to that which would make the immediate elimination of such a tax have a very different impact on Puerto Rico than in other situations. And, remember, the proposal that we are making with respect to 936 is simply for a reasonable phaseout which takes account of the unique history of Puerto Rico.

The **Chairman**. What does the Court mean when it talks about actual geographic discrimination?

Professor **Gewirtz**. I think it means that if Congress doesn't have a reason, has not exercised its considered judgment. I did try to mark some of those passages in the opinion. And I think the flavor that comes through there loud and clear is that when Congress is trying to deal seriously with a complex problem in making a considered judgment, the Supreme Court is not going to intervene and say the Constitution stands in its way.

And, in fact, the Supreme Court never has, never. It has never struck down a tax on uniformity grounds. It is because the Supreme Court appreciates that these are very difficult problems and that as long as Congress is doing its best to legislate and to solve those problems in a way that makes policy sense, it is permitted to do so.

The **Chairman**. What again is the Court saying when it says, "A tax is uniform when it operates with the same force and effect in every place where the subject of it is found"? What do they mean "the subject of it"? Don't they mean that the subject has to be different as opposed to the need of the place for revenue?

Professor **Gewirtz**. I don't think the subject has to be different in the sense that oil has to be in one place and coal in other place. What has to be different is there has to be some geographically different problem in Congress' judgment. I think that is all that it means. That sentence has to be read in context of everything else in the opinion.

My core point, remember, is to just get this issue of the Constitution out of the picture so that we can have a serious policy debate about what is the right thing. My point is that if you conclude that it would be best for Puerto Rico and best for the United States with a new state of Puerto Rico to have some transitional continuation of 936, nothing in the Constitution, nothing in the Supreme Court of the United States should stop you or should confuse the issue.

The **Chairman**. Well, I think you are probably right, but I'm a little bit concerned about that. I am quite sure that it is at least ambiguous enough that there would be a vigorous lawsuit brought and tested. I would rather have your side of the case certainly I say than my side. I play the devil's advocate with you. I don't even believe that necessarily myself, but I think there is a question. There is certainly a distinction between this situation and the Gewirtz—I mean, the Ptasynski case.

Professor **Gewirtz**. I'm not going to be the plaintiff in that lawsuit, Senator Johnston. [Laughter.]

Let me just say in closing it is worth keeping in mind I think this is a unanimous opinion. I really think that is significant. We know that the Supreme Court—when there are little quibbles and interesting issues which will divide the Court in the future, we get separate opinions. I can't tell you how many Supreme Court opinions these days have three, four, five opinions. This is a unanimous opinion in both its literal wording and in the spirit of the opinion.

Look at the last paragraph about spirit of deference to Congress. I really think that there can be no reasonable disagreement about the scope of this opinion.

The **Chairman**. I think you are probably right.

Prepared Statement of Kenneth W. Gideon

Mr. Chairman and Members of the Committee: It is a pleasure to be here today on behalf of the Administration to discuss Senate Bill 712, a bill "To Provide for a Referendum on the Political Status of Puerto Rico." This bill would give the people of Puerto Rico an historic opportunity to vote upon the status of that island. The bill would provide for a referendum, to be held in 1991, in which the Puerto Rican people could decide among the options of statehood, independence, or commonwealth status.

The Administration strongly supports the right of the people of Puerto Rico to decide for themselves the status of the island. Further, as the President has noted a number of times, he favors the admission of Puerto Rico to the Union as a State, thereby assuring the people of Puerto Rico an equal standing with other United States citizens. By providing for a status referendum, the U.S. Government would be assisting the Puerto Rican people to exercise the basic political right to determine the nature of their government.

As I indicated in testimony before the Committee on Energy and Natural Resources earlier this year, the Administration firmly believes that the Puerto Rican people should be given an opportunity to express their will in a manner that recognizes the historic and fundamentally political nature of their decision of self-determination. The importance of the decision they face as a people transcends narrow concerns about specific aspects of economic or fiscal structures.

The Administration recognizes, however, the difficulty of isolating the impact of tax and financial issues from the question of Puerto Rico's future status. We also recognize the desire of the Puerto Rican people to have a referendum which is self-executing in its important features. This desire was eloquently and unanimously expressed by the representatives of the various Puerto Rican political parties who also testified before the Committee on Energy and Natural Resources earlier this year. We therefore accept the proposition that the important economic features of each option must be identified to allow an informed choice.

In view of these competing considerations, the Administration today endorses Senate Bill 712 currently before your Committee. We believe that the bill strikes an appropriate balance between two important goals. First, it informs the Puerto Rican people of the broad outline of the fiscal and economic structures applicable to each of the three status options. Yet it preserves this essentially political choice free from a welter of details, transitional rules, and administrative provisions best addressed after the political choice is made.

We believe that the substance of the proposed tax and economic results under each of the three options in Senate Bill 712 represents a reasonable resolution of the difficult policy choices faced by the drafters of this legislation. In particular, with respect to the statehood option, we support the decision to defer until January 1, 1994 the application of Federal tax laws, other than those relating to excise taxes. This provision will give both U.S. and Puerto Rican tax authorities the necessary time to ensure a smooth transition from one system to the other. In addition, we believe that it will assist in the process of developing detailed transitional rules for Congress to consider enacting before the January 1, 1994 changeover.

We also believe that the proposed phase-out under the statehood option of the section 936 credit during the period from 1994 through 1997 reflects a sensible approach to minimizing the economic dislocation that could result from an abrupt change in status. The future of section 936 is of course a significant concern to the Puerto Rican people and how it should be treated under this bill presents a difficult decision for Congress. We believe that the consideration given to this issue by the Committee on Energy and Natural Resources earlier this year has produced a good and defensible balance among the different interests at stake.

It is not, however, the only alternative that might have been adopted. In particular, a uniform phase-out of section 936 under both the statehood and commonwealth options would eliminate what is perceived by many as a bias in the bill toward commonwealth. Nevertheless, we recognize that section 936 cannot be viewed in isolation from the other costs and benefits affected by this referendum, and we seek an opportunity for the Puerto Rican people to make a fundamental decision about their political future, not a straw poll on relative tax benefits. We particularly appreciate the difficulties presented in making each option fairly equivalent. Accordingly, the Administration will accept the treatment of section 936 proposed in the current bill and the related congressional judgment that the economic provisions set forth for the three alternatives are fairly equivalent.

With respect to the proposed cover-over of certain tax revenues to the Treasury of Puerto Rico under the statehood option, the Administration has certain concerns.

which I will discuss in more detail later. In general, however, we stand ready to cooperate with this Committee in developing workable mechanisms for ensuring that the cover-over approach to statehood grants can be smoothly implemented.

In each of the areas I have just mentioned, we anticipate that further legislation by Congress may be necessary after the referendum to cover particular details of the transition. In a separate attachment to this testimony (Appendix II), I have highlighted some of the issues that I think such legislation might have to cover. By mentioning these issues, however, I do not suggest that they be addressed by this bill. As previously indicated, the Administration's view is that such relatively technical details would be most appropriately worked out after the Puerto Rican people have had an opportunity to express their political choice.

The Administration also endorses, subject to some technical comments which I shall discuss presently, the bill's approach to fiscal matters under the independence and commonwealth options.

Each of the political options covered by the bill—statehood, independence, and commonwealth status—raises special issues that affect the tax systems of both Puerto Rico and the United States. We believe that the bill should clearly define the basic tax structure of each status option. However, we also believe that the fundamental political choice of the future of Puerto Rico should be completed prior to congressional development of technical transitional rules for any new tax system. In general, the level of detail in the current bill acceptably balances these objectives. The remainder of my testimony, therefore, will identify the tax results of this bill's provisions as drafted, note ambiguities remaining in the bill, and highlight issues which the bill's tax provisions do not currently address.

I. GENERAL REVENUE EFFECTS OF S. 712

Revenue estimates and projections for each of the tax provisions of S.712 are provided in an attachment to this testimony (Appendix I). It is difficult to present very precise estimates of the Federal revenue consequences of the various options described in the bill, but it may be helpful for purposes of this discussion to consider some rough guidelines.

A. Section 936 Phase-Out

Both the independence and the statehood options assume some form of reduction of the tax incentives currently provided under Internal Revenue Code ("Code") section 936. While no change to section 936 is currently contemplated under the commonwealth option, we expect that Congress would continue to review and revise section 936 and other tax benefits as necessary should that option be selected.

We estimate that in fiscal year 1989 the tax benefits received by section 936 corporations amount to about $1.9 billion, and that a phase-out of section 936 would yield a net reduction of approximately 25 percent of income subject to U.S. tax. A phase-out of section 936 benefits probably would cause some economic dislocation on Puerto Rico, at least in the short run. Employment in 936 companies now accounts for about 12 percent of total Puerto Rican employment. However, it is very difficult to project the extent to which Federal tax collections would be affected by any such dislocation. Under the statehood option, collections of personal income tax may be somewhat reduced for a time; but, as discussed below, fully phased-in Federal personal income tax collections from Puerto Rico can be expected to be relatively modest.

B. Imposition of Federal Income Tax

The statehood option presents the issue of how a newly-imposed Federal income tax will interact with a Puerto Rican state tax system. The effects of this change must be considered for both individual and business tax revenues.

The extension of Federal income tax to individuals in Puerto Rico would perhaps raise some $500 million per year at 1989 levels net of all earned income credits. In comparison, the Puerto Rican government collected about $900 million in personal income taxes in their fiscal year ending June 30, 1989, or about 30 percent of total Puerto Rican revenue from local sources. This amounted to only about 5 percent of personal income in Puerto Rico.

As a State, Puerto Rico could design a tax system which would maintain combined revenue levels. It might choose to follow other States in relying more heavily on sales taxes. Under either the commonwealth or independence options, Puerto Rico could continue a system similar to the current Puerto Rican tax.

With respect to business taxation, the Puerto Rican government now collects about $1.0 billion a year in taxes from business, which represents about 10 percent of business income. Since about 40 percent of this revenue is collected from exempt section 936 corporations, Puerto Rico may experience some loss of revenue if a phase-out of section 936 benefits causes any of these companies to reduce their Puerto Rican operations.

Under statehood, Federal corporate tax would also apply to Puerto Rican business that does not now benefit from section 936. This includes locally incorporated, or foreign, companies as well as section 936 corporations that do not receive a full or partial exemption from Puerto Rican tax. This would increase Federal revenues by about $325 million per year at 1989 levels.

C. Federal Excise Taxes

Puerto Rico does not now pay Federal excise taxes. Assuming that by virtue of its becoming a State, U.S. excise taxes became applicable within Puerto Rico, this change would result in an increase in revenues of approximately $250 million per year, which under the current bill would be rebated to the Puerto Rican government as a statehood grant. In addition, approximately $100 million per year in customs duties would continue to be collected and segregated for the benefit of Puerto Rico under the current bill.

D. Puerto Rican Expenditures

Finally, Puerto Rico may choose to make adjustments on the expenditure side instead of, or in addition to, adjustments on the revenue side. Government employment now accounts for 23 percent of total employment in Puerto Rico. In addition, Puerto Rican government enterprises play a very important role in the Puerto Rican economy. A reduction of these expenditures, either to reduce taxes or to provide incentives to business may, therefore, be one of the consequences of any phase-out of current provisions.

E. Economic Effects of Independence Option

Under the independence option, the elimination of section 936 benefits would increase Federal tax collections if 936 corporations remained in Puerto Rico as U.S. corporations or if they moved back to the United States. However, some Puerto Rico-oriented companies in routine industries, such as apparel or food processing, may choose to reincorporate as Puerto Rican companies. The Federal revenue gain may therefore not be quite as large as under statehood. Under the independence option, Federal excise taxes would only apply, as they do now, on imports from Puerto Rico; and the Federal Government would not collect any customs duties on goods imported into Puerto Rico. However, this would be offset somewhat by increased customs collections on imports from Puerto Rico. In addition, there might be a modest revenue pickup from withholding taxes on dividends paid to Puerto Rican residents, etc.

With the above rough estimates in mind, I would now like to turn to a technical review of the bill as drafted. Before discussing the bill's specific provisions, however, it may be useful to briefly summarize the tax relationship that currently exists between Puerto Rico and the United States.

II. SUMMARY OF EXISTING TAX LAWS

Generally speaking, the Commonwealth of Puerto Rico is not considered part of the "United States," as that term is used in the Internal Revenue Code (see section 7701(a)(9) and (d)). Thus, Puerto Rico has its own tax laws, and the U.S. internal revenue laws do not extend fully to Puerto Rico. Depending upon the nature of the tax involved, different methods have been used to allocate taxing jurisdiction between the two governments.

A. Income Taxes

1. United States Income Tax

The United States generally taxes the worldwide income of U.S. citizens, resident alien individuals, and domestic corporations. It also taxes the U.S. income of foreign corporations and nonresident alien individuals. Two important provisions affect the U.S. taxation of U.S. persons with Puerto Rican income.

First, under section 933 of the Code, the United States exempts the Puerto Rican source income of individuals who are bona fide residents of Puerto Rico. Consistent with section 933, U.S. citizens resident in Puerto Rico may be exempted from the withholding of Federal tax on their Puerto Rican source earnings (see section 3401(a)(8)).

Second, section 936 provides an effective exemption for certain Puerto Rican income of qualifying U.S. corporations that elect its benefits and that are engaged in business in Puerto Rico. The exemption is granted in the form of a "tax sparing" credit, under which the company's U.S. tax liability on its qualifying Puerto Rican income is reduced by a credit for a hypothetical Puerto Rican tax equal to the amount of U.S. tax due on that income. Because Puerto Rican tax law provides generous exemptions to certain business operations there, section 936 corporations enjoy a very low aggregate effective tax rate.

2. Puerto Rican Income Tax

Puerto Rico is authorized by Congress to enact its own income tax system. In 1954, the Puerto Rican legislature adopted its present income tax system, which is based on the U.S. Internal Revenue Code of 1939. In the absence of a tax exemption grant, Puerto Rico taxes all Puerto Rican source income earned by U.S. and foreign persons (including corporations) and taxes the worldwide income of all Puerto Rican resident individuals and Puerto Rican corporations.

The Puerto Rican individual income tax rates are somewhat higher than corresponding U.S. rates, and the Puerto Rican personal exemptions are somewhat lower than the U.S. exemptions. This will remain true even after tax law changes enacted by the Puerto Rican legislature in 1987 are fully phased in.

Under a series of industrial incentives laws, Puerto Rico has granted generous exemptions to certain business and investment income of qualifying businesses. Thus, while Puerto Rico's nominal corporate tax rate is slightly higher than the U.S. corporate tax rate, the exemption grants significantly reduce the effective Puerto Rican corporate tax rate.

B. Estate and Gift Taxes

1. United States Estate and Gift Taxes

The United States taxes the worldwide estates of U.S. citizens and noncitizen decedents domiciled in the United States, as well as the U.S. situs estates of nondomiciliary aliens. The United States allows a foreign tax credit for Puerto Rican estate taxes imposed on the Puerto Rican situs estate of U.S. decedents (see section 2014(g)). Similarly, the U.S. gift tax applies to all gifts by U.S. citizens and noncitizen domiciliaries, and to gifts of U.S. situs property by nondomiciliary aliens. For purposes of the U.S. estate and gift taxes, U.S. citizens resident in Puerto Rico who are citizens solely because of being citizens of Puerto Rico or because of their birth or residence in Puerto Rico are treated as nondomiciliary aliens, taxable only on transfers of U.S. situs property (see sections 2208, 2209, 2501(b), and 2501(K)).

2. Puerto Rican Estate and Gift Taxes

Puerto Rico generally taxes the worldwide estate of Puerto Rican resident decedents and the Puerto Rican situs estate of nonresident decedents. The amount of Puerto Rican estate tax on the Puerto Rican situs estate of a U.S. citizen resident in Puerto Rico can depend upon whether the United States includes that property in the U.S. gross estate. Puerto Rico allows a credit for U.S. estate taxes paid on the U.S. situs property of a Puerto Rican resident decedent. Similarly, Puerto Rico taxes all gifts by Puerto Rican resident donors and gifts of Puerto Rican situs property by nonresident donors.

C. Employment Taxes

The various Federal employment taxes, including the self-employment tax (section 1401), the social security or FICA taxes (sections 3101 and 3111), and the unemployment insurance or FUTA tax (section 3301), are fully applicable within Puerto Rico as in the United States. (See sections 1402(b), 3121(e), and 3306(j)).

D. Excise/sales Taxes

1. U.S. Excise Taxes

The United States does not impose a broad-based Federal sales tax. The Code does, however, impose a wide variety of excise taxes, including retail taxes, manufacturer taxes, services taxes, environmental taxes, alcohol taxes, etc. Generally, these taxes do not apply within Puerto Rico because of an exemption in the Puerto Rico Federal Relations Act (48 U.S.C. sec. 734).

Code sections 7652 and 7653 provide special rules with respect to taxes on articles manufactured in Puerto Rico and shipped into the United States, and vice versa. Basically, these rules treat such shipments as if they were imports from or exports to a foreign country. Under section 7652, articles of Puerto Rican manufacture shipped into the United States are subjected to a Federal tax equal to the amount of the Federal tax that would apply to similar articles manufactured in or imported into the United States. For example, by virtue of section 7652, the United States imposes a tax at the rate of $12.50 per proof gallon on distilled spirits produced in

Puerto Rico and shipped into the United States, because that is the tax imposed on U.S.-produced distilled spirits.

The special feature about these rules, however, is that they call for a rebate or "cover-over" of these equalization taxes to Puerto Rico. Section 7652(a) generally requires the United States to cover over to the Puerto Rican Treasury the amount of these Federal equalization taxes imposed on Puerto Rican articles shipped into the United States. In addition, section 7652(e) generally requires the United States to cover over to Puerto Rico (and, under a sharing arrangement, to the Virgin Islands) the Federal tax collected on all rum imported into the United States. By virtue of section 7652(f), however, the amount of these alcohol taxes to be covered over to Puerto Rico cannot exceed $10.50 per gallon.

Section 7653(b) provides that articles otherwise subject to Federal taxes will be exempt from the normal taxes if they are shipped into Puerto Rico. Instead, section 7653(a) imposes a tax on such items equal to the amount of Puerto Rican tax applicable to similar items manufactured in Puerto Rico.

2. *Puerto Rican Excise Taxes*

Pursuant to excise tax amendments enacted in 1987, Puerto Rico imposes a 5 percent excise tax on a broad range of commodities, transactions, and occupations.

I would now like to turn to a review of the issues presented by the tax provisions under each of the three political options described in the bill.

III. COMMENTS ON STATEHOOD OPTION

A. *Status of Puerto Rican Tax Laws*

Title II of S. 712, relating to the statehood option, contains two sections which are particularly relevant to the continued application of Puerto Rican tax laws and their future interaction with the Federal tax system—

- Section 208 (Laws in Effect) generally provides that Puerto Rico's territorial laws remain in force after statehood until amended or repealed by Puerto Rico. In addition, all Federal laws will have the same force and effect within the State of Puerto Rico as they had immediately prior to admission, except as provided in section 213 or elsewhere in the bill.
- Section 213 (Economic Adjustment) provides a number of special rules relating to the adjustment of Puerto Rico's tax status. In particular, the "current tax treatment applicable to Puerto Rico" is continued until January 1, 1994. Effective on that date, Federal internal revenue laws will apply within Puerto Rico in the same manner as within other States.

We support the bill's approach of keeping the Puerto Rican local tax system in place until amended by the Puerto Rican legislature. The deferred application of Federal tax should give Puerto Rico sufficient time to develop appropriate measures of state level taxation. Moreover, as the current bill provides, these adjustments to the local tax structure should ultimately be made by Puerto Rico rather than by the Federal government. We recommend, however, that several clarifications be made, perhaps in legislative history, with respect to the provisions addressing the study and review of appropriate transition rules.

First, section 208(b) provides for a Presidential Commission on Federal Laws to recommend to Congress which Federal laws should continue to apply to the new State of Puerto Rico. It is unclear under the current bill whether this Commission will consider the application of Federal tax law to Puerto Rico. To the contrary, we believe that the bill should provide that the review and adoption of any transition or other provisions affecting Federal internal revenue laws are beyond the scope of the Commission's mandate. To the extent such issues are left unresolved by S. 712, they should be addressed by Congress and the Administration through subsequent legislation.

Second, section 213(d) provides that the Secretary of the Treasury shall consult with the Governor of Puerto Rico on "the transition of the new State from a foreign tax jurisdiction." The intended scope of these consultations is ambiguous. We believe such consultations should be directed toward providing Puerto Rico with assistance in developing a new state level tax system, particularly in assessing the effects and likely impact of a combined Federal-State tax as of 1994. The application of Federal tax laws in Puerto Rico should, however, be addressed through the normal legislative process of the Congress.

B. *Application of Federal Excise Taxes*

Under section 213(a), all Federal excise taxes are extended to Puerto Rico as of its date of admission as a State. In general, we agree with this result. To ease the administration of these new taxes, however, it would be preferable to begin the application of the new excise taxes on the first January 1 following statehood. Assuming the admission of Puerto Rico as a State in October of 1991, this effective date for the excise taxes would be January 1, 1992.

C. Application of Other Federal Tax Laws to Puerto Rico

1. Transition for Federal Tax

Deferral Date of January 1, 1994. Under section 213(d), Federal internal revenue laws would apply to Puerto Rico effective January 1, 1994. In general, this deferral of two years after statehood is an appropriate period for the Puerto Rican and U.S. governments to adjust their respective tax systems into a combined Federal-State regime.

With respect to our administration of this transition, extending Federal taxation to Puerto Rico does not pose a serious problem. The Internal Revenue Service estimates on a preliminary basis that the change would involve approximately $5 million in start-up costs and $12 million annually for operating a district office in Puerto Rico. If the Puerto Ricans chose statehood, it would take between one and two years after the referendum to cost the additional resources, to have the necessary funding approved in the IRS budget, to staff the district, and to make the system operational. Thus the process should be completed prior to the January 1, 1994 effective date. Although income tax returns would not be filed for fifteen months after that effective date, it is necessary to have the new system in place from the outset since withholding and estimated tax payments would begin during the first quarter.

Apart from the length of any deferral period, we strongly support keeping an effective date of January 1 for the imposition of Federal tax laws in Puerto Rico. Initiating the new system at the beginning of a calendar year is essential to avoid serious confusion for taxpayers and administrative problems for the IRS.

2. Pre-1994 Tax Treatment

Section 213(d) of the bill also provides that prior to January 1, 1994, "the current tax treatment applicable to Puerto Rico is continued." We assume this is a reference solely to the application of Federal internal revenue laws and is not intended to freeze in place the current Puerto Rican system of tax until 1994. As explained above, we would support giving the Puerto Ricans full autonomy over how and when they effect their transition from the current commonwealth system to a new state tax structure. Accordingly, we recommend a clarification that this language applies only to Federal taxes.

3. Federal Taxation of Individuals

With respect to the taxation of individuals, the bill apparently contemplates the elimination of the exemption for Puerto Rican source income under current Code section 933. Moreover, this change should coincide with the effective date for the application of Federal tax law on January 1, 1994. We recommend that the current bill clarify this intent.

Accordingly, with respect to U.S. citizens resident in Puerto Rico, the extension of the income tax laws presumably means that they will become subject to Federal taxes on their Puerto Rican source income earned on or after January 1, 1994. The bill would also seem to require that these individuals become subject to the withholding of Federal income taxes on their Puerto Rican earnings. With respect to non-U.S. citizens resident in Puerto Rico, their U.S. income tax status would depend upon their classification as either resident aliens or nonresident aliens, taking into account the inclusion of Puerto Rico as part of the United States for purposes of applying the resident alien definition of Code section 7701(b).

4. Federal Taxation of Puerto Rican Corporations

The extension of the Federal income tax regime to Puerto Rico also raises a number of issues for Puerto Rican corporations. Because of the inclusion of Puerto Rico as part of the United States after admission, these corporations, which are now treated as foreign corporations for U.S. income tax purposes, would be treated as domestic corporations. This would generally mean that Puerto Rican corporations would become subject to full U.S. income tax on their worldwide income. The recharacterization of Puerto Rican corporations as domestic corporations could have a number of corollary effects on those corporations, their affiliates, shareholders, and lenders. We believe the current bill appropriately reserves such issues for transitional rules in subsequent legislation. However, we believe that implementing legislation should not confer double benefits on such corporations. (See further discussion in Appendix II).

5. Phase-Out of Section 936 Benefits

As a proviso to the 1994 effective date, Section 213(c) of the bill states that the credit under Code section 936 shall be reduced to 80% in 1994, 60% in 1995, 40% in 1996, 20% in 1997, and shall be eliminated thereafter. As I stated previously, we support this provision as a sensible approach to avoiding the economic dislocation that could result from the abrupt termination of this benefit. Nevertheless, I would simply raise the following concerns which remain with respect to congressional adoption of this proposed phase-out.

We recognize that any continuation of section 936 after statehood would have to be tested under the uniformity clause of the U.S. Constitution (Art. I, sec. 8, cl. 1), which broadly requires taxes to be uniform throughout the United States. We defer to the Justice Department's views on this issue and I understand a Justice Department witness will address the issue for the Committee. We would encourage fact-findings by Congress to support a congressional determination that providing transitional tax benefits to Puerto Rico is appropriate and that any section 936 transition adopted is well suited to achievement of congressional goals.

Many technical issues are also presented by a phase-out of section 936. The bill properly defers such issues for transitional legislation. (See Appendix II). However, Congress should clarify whether the bill's extension of section 936 benefits is intended to apply to newly-electing corporations, and whether Puerto Rican corporations are eligible for these phased-out benefits after statehood. In making this latter determination, it should be noted that the Puerto Rican companies which were exempt from Puerto Rican tax under the commonwealth's incentives tax exemptions will be a different class of companies than those which meet the section 936 requirements. As a result, Puerto Rican corporations that had been fully exempt under the Puerto Rican tax system might become subject to tax for the first time if they failed to qualify for exemption under section 936.

The section 936 exemption applies not only to Puerto Rican business profits of U.S. corporations, but also to their Puerto Rican source investment income derived from qualifying investments of those profits. The latter category of investment income, known as QPSII ("qualified possession source investment income"), can include income from lending section 936 funds through a Puerto Rican financial institution to qualifying borrowers in beneficiary countries of the Caribbean Basin Initiative (CBI).

It should be recognized that the proposed phase-out of section 936 would eliminate the CBI tax incentive in its present form. The current role of Puerto Rican financial institutions—holding funds earned by section 936 corporations operating in Puerto Rico and lending them out for qualified CBI investments—would be eliminated without the QPSII tax benefits under section 936. Moreover, the current magnitude of section 936 operations outside of Puerto Rico is not sufficient to permit the transfer of this system to another U.S. possession. As part of its subsequent transitional legislation, Congress may want to consider appropriate measures for continuing similar benefits with respect to CBI investments.

6. Federal Tax Transitional Rules

Congress reserves its authority under bill section 213(d) to enact "transitional rules or other provisions" modifying the 1994 application of Federal internal revenue laws in Puerto Rico. In an attachment to this testimony (Appendix II), we have described some of the issues which will be raised by the extension of Federal tax law to the State of Puerto Rico. It is essential that the bill provide a flexible mechanism for resolving these issues and the myriad of other complex tax questions that will be presented by any statehood transition. As I stated at the outset of this testimony, we believe the current bill provides such a mechanism by setting a general effective date and expressly retaining congressional authority to establish appropriate transitional rules.

D. Statehood Grants and Assistance

Section 213(e) of the bill provides for several mechanisms for covering over of Federal revenues to the Puerto Rican Treasury. First, the cover-over of the $10.50 per gallon rum excise tax and the current cover-over system applicable to certain custom duties are continued after statehood. Second, the revenues collected from any new Federal excise tax imposed in Puerto Rico after statehood will be covered over. With respect to these two provisions, the bill includes a Congressional "compact" not to alter the cover-over of funds until after October 1, 1998. Finally, the revenue derived from the application of the Federal internal revenue laws in 1994 and 1995 within the State of Puerto Rico will also be covered over

We recommend that the Committee consider clarifying the current bill language referring to "all revenues" derived from Federal internal revenue laws in 1994 and 1995. For example, it is unclear whether the provision covers estate and gift tax and employment taxes as well as income taxes. Perhaps more important, the bill should state whether the revenue gains attributable to the partial phase-out of section 936 credits in 1994 and 1995 are intended to be covered over to Puerto Rico.

We agree with the proposition that Puerto Rico should receive sufficient Statehood grants and assistance to ease its transition from commonwealth status. We note, however, that the cover-over mechanism currently applied in the context of other U.S. possessions has presented administrative problems in the past and involves complex procedural issues of measurement and timely payment. (See discussion of transitional issues in Appendix II.) Such difficulties could be significantly magnified with respect to the variety of revenue sources and the substantial amounts contemplated by section 213(e) of the bill. Moreover, it is in the interest of both the U.S. and Puerto Rican governments to develop a procedure for calculating and remitting the appropriate amount of these payments with minimum controversy.

Accordingly, while the bill language should describe clearly the parameters of these intended grants, we recommend that the Committee avoid tying such benefits to a rigid cover-over mechanism; rather, Congress should preserve its flexibility for resolving the mechanical issues of measurement and remittance of such grants through transitional rules in subsequent legislation. In particular, the language describing the Congressional "compact" not to alter these transfers for seven years should be clarified so that it prohibits neither the implementation through transitional rules of an appropriate payment mechanism nor future procedural adjustments to that system.

IV. COMMENTS ON INDEPENDENCE OPTION

Title III of S. 712 deals with the independence option and contains several provisions which specifically address a number of tax and trade issues. Section 308 deals with the status of pre-existing law upon proclamation of independence. Section 317 covers a few specific tax issues. Section 319 addresses the tax treatment of Puerto Rican Government bonds.

A. Status of Pre-existing Laws

Under section 308, all U.S. laws applicable to the Commonwealth of Puerto Rico immediately prior to independence shall no longer apply in the Republic of Puerto Rico upon proclamation of independence, except as otherwise provided in Title III of the bill or in any separate agreements concluded between the United States and the Republic of Puerto Rico. For purposes of U.S. tax laws, this provision presumably means that those Federal tax laws that treat Puerto Rico either as part of the United States or as a possession of the United States shall no longer apply, and that Puerto Rico shall instead be treated exclusively as a foreign country for U.S. tax purposes. Thus, for example, U.S. citizens living and working in Puerto Rico could become eligible for the foreign earned income exclusion under Code section 911. Generally, except for the section 911 exclusion, income derived by U.S. citizens and residents from foreign sources is subject to U.S. tax with a credit for foreign income taxes. In addition, we assume that this provision means that special provisions applicable to the Commonwealth of Puerto Rico, such as the cover-over of Federal excise taxes imposed on Puerto Rican-produced articles entering the United States, shall no longer apply. It would be useful for these understandings to be reflected in the legislative history, if not in the statute itself.

Under section 308(a)(3):

> all laws and regulations of the Commonwealth of Puerto Rico in force immediately before the proclamation of independence shall continue in force and shall be read with such modifications, adaptions, qualifications, and exceptions as may be necessary to bring them into conformity with the Constitution of the Republic of Puerto Rico, until such time as they shall be replaced with new legislation . . . .

In other words, Puerto Rico's tax laws would generally remain in effect as national tax laws in an independent Puerto Rico, until changed by new legislation.

B. Elimination of Section 936

Section 317(a) specifically provides that the section 936 credit currently allowed under the Code shall, upon the proclamation of independence, become unavailable with respect to income or investments from activity in Puerto Rico. This automatic repeal of section 936 as it relates to Puerto Rico is essential to eliminate any difficulties that otherwise arise with respect to a number of income tax treaty partners of the United States who have effectively been granted most favored nation status with regard to tax sparing incentives. No such difficulties would arise, however, if Congress were to decide to cushion the elimination of section 936 with transition grants to the Republic of Puerto Rico.

C. Negotiation of Tax Treaties

Section 317(b) provides that the Joint Transition Commission, to be appointed by the President of the United States and the Presiding Officer of the Constitutional Convention of Puerto Rico, shall establish a Task Force on Taxation to negotiate appropriate tax treaties between the United States and Puerto Rico. Such treaties would be approved by the two governments in accordance with their respective constitutional processes. In light of the level of economic integration between Puerto Rico and the United States, the Administration certainly supports the notion that tax treaties could appropriately be negotiated between the two countries. Inasmuch as the negotiating authority for such treaties has generally been delegated to the Treasury Department within the Executive Branch, the Administration would recommend that the legislative history to this provision clarify that the appropriate U.S. representatives to any such Task Force would be the Treasury Department officials responsible for the negotiation of tax treaties.

D. Continuation of Exemption for Interest on Puerto Rican Government Obligations

Section 319 of the independence option provides that any obligations of the Commonwealth of Puerto Rico (including its municipalities and instrumentalities) which are valid and outstanding upon the date of the proclamation of independence shall be assumed by the Republic of Puerto Rico, and their tax treatment shall be unaffected "to the extent that similar obligations issued by states are so treated." We understand this exemption to be limited to those obligations issued prior to the date of proclamation of independence, and not to obligations that are either original issuances or refinancings on or after that date. Moreover, we understand the scope of this exemption to be co-extensive with the exemption for U.S. municipal bonds, as that exemption may be amended from time to time. Here again, the legislative history to the statute could usefully confirm these understandings.

V. COMMENTS ON THE COMMONWEALTH OPTION

As I have previously indicated, the Administration supports the approach of S. 712 with respect to the tax treatment of Puerto Rico under each of the status options. The bill's commonwealth option would not involve any changes to the substantive tax laws applicable to Puerto Rico. While alternative approaches could have been taken, such as one which would have called for more equivalent treatment of section 936 and other tax provisions across the three options, we believe that the current bill reflects a good and defensible balance. We continue to believe, however, that Congress should make clear that tax benefits such as section 936 cannot be regarded as benefits that will last indefinitely under commonwealth status, but rather as incentives which Congress will continue to review and revise as necessary.

Sections 403 and 404 of the commonwealth option contain a number of provisions concerning Puerto Rican Government participation in the making of Federal law relating to Puerto Rico on which I would like to comment.

A. Applicability of Federal Law to Puerto Rico

Section 403(a) would authorize the Governor of Puerto Rico to certify to Congress that the legislature of Puerto Rico has adopted a resolution stating that a Federal law, or provision thereof, should no longer apply to Puerto Rico because there is no overriding national interest in such applicability and it does not serve the interests of Puerto Rico. Any such law would then become inapplicable to Puerto Rico if Congress enacts a joint resolution approving the recommendation of the Government of Puerto Rico. Section 403(b) contains procedures for the expedited Congressional review of the recommendation of the Government of Puerto Rico that a Federal law should no longer apply.

The Administration has serious concerns about this procedure which are not limited to its effect on tax laws. We believe that it inappropriately impinges on the enactment and amendment of legislation. It also places undue authority in the hands of the Governor of Puerto Rico to affect Federal legislation, with troubling implications for the equitable treatment of Puerto Rico as compared with the states and territories.

We also have concerns about the extent to which such a procedure, if utilized in connection with tax laws, could be disruptive to the smooth administration of the tax system and could create uncertainty for taxpayers. Moreover, we believe that the enactment of tax legislation, like other legislation, should follow standard Constitutional and legislative procedures. We strongly oppose an earlier proposal which could have rendered Federal statutes automatically inapplicable to Puerto Rico if they were inconsistent with a vaguely described principle of commonwealth.

B. International Agreements

Section 403(d) of the bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States. Currently, Puerto Rico does not have the authority to negotiate or enter into international double taxation or similar agreements in its own right. An outright grant of independent tax treaty authority to Puerto Rico would significantly complicate the negotiations of United States treaties and quite possibly undermine several existing conventions. While we believe that this provision appropriately provides flexibility in the general area of Puerto Rico's international agreements without sacrificing the President's control in this area, we believe that Congress should explicitly deny independent tax treaty authority in the commonwealth option.

C. Regulatory Review

Section 404 sets forth procedures by which the Governor of Puerto Rico may require the review of regulations which apply to Puerto Rico but which the Governor determines are inconsistent with the Federal policy stated in section 402 of the bill. That policy is to enhance the commonwealth relationship to enable the people of Puerto Rico to accelerate their economic and social development, to attain maximum cultural autonomy, and in matters of government to take into account local conditions in Puerto Rico.

The Administration also has serious concerns about the effect of this provision on the Federal rule-making process. The provision would grant the Governor of Puerto Rico far greater influence over that process than that accorded to the governors of the states or territories. Moreover, it would inappropriately tilt the balancing of interests that agencies undertake in their rule-making in Puerto Rico's favor, to the detriment of other interest groups. It represents an unjustified intrusion into a decision-making process that is already adequately governed by the provisions of the Administrative Procedure Act.

We believe that the application of this provision in the tax area in particular would unreasonably complicate the fair and efficient administration of the tax system. For example, when the Internal Revenue Service publishes a final regulation, this provision would require that the IRS include in the preamble the arguments submitted to the IRS that raised a question about a proposed regulation's consistency with the policy of section 402. As you know, an enormous number of the regulations published by the IRS apply, directly or indirectly, to Puerto Rico, whether they deal with residents of Puerto Rico, income arising there, transactions occurring there, or other such matters. Thus, the bill's provision could be read to require the IRS to respond specifically and in detail to points raised by the Governor of Puerto Rico on regulations having impact as general as the passive activity loss regulations if he felt they had an undesired impact on investments in Puerto Rico.

In addition, section 404(c) provides that when an agency publishes a final rule that applies in Puerto Rico (other than a rule issued after notice and hearing required by statute), the Governor of Puerto Rico may submit to the agency within 30 days his determination that the rule is inconsistent with the policy of section 402. The agency is then required to publish a finding in the Federal Register within 45 days, stating whether the rule will apply in Puerto Rico. If the agency finds that the rule should apply to Puerto Rico, the Governor can challenge that finding in a Federal court of appeals. In the Administration's view, this procedure would give the Governor wholly inappropriate influence over the Federal rule-making process.

We believe that the Administrative Procedure Act currently provides reasonable procedures for ensuring that Federal regulations are promulgated in a manner that guarantees appropriate attention to all relevant considerations. We would regard this provision's requirements as a most undesirable precedent for deviating from those procedures. Moreover, we think that they could seriously impair the efforts of an agency like the IRS to promulgate regulations in a manner that promotes maximum efficiency and certainty.

APPENDIX I.—REVENUE ESTIMATES AND PROJECTIONS

The following chart shows the Federal revenue collections that are estimated to result from implementation of either the statehood or the independence option under S. 712 through fiscal year 1994 and projections of revenues for the six fiscal years thereafter. Because economic projections are not made by the Treasury, Council of Economic Advisors, or the Office of Management and Budget for years after 1994, the projections shown for 1995–2000 are based on a continuation of the fiscal year 1994 economic forecast in later years. The section 936 projections, however, are based on the historic patterns of section 936 tax expenditure growth which have been significantly in excess of U.S. economic growth.

Except in the case of customs duties and rum excise taxes, these figures reflect projected increases in Federal revenue collections over existing law. As indicated below, many of these amounts would be subject to a cover-over to the State of Puerto Rico. Except as otherwise indicated, these figures reflect an effective date of 1/1/94 for Federal tax law changes. These figures do not assume any change in Puerto Rican tax law.

[In millions of dollars]

	ESTIMATES FY—			PROJECTIONS FY—					
	1992	1993	1994	1995	1996	1997	1998	1999	2000
STATEHOOD:									
Phase-Out Sec. 936	45	128	538	1204	1889	2610	3325	3741	3994
New Excise Taxes[2]	[1] 213	[1] 295	[1] 309	[1] 325	[1] 341	[1] 358	[1] 376	395	414
Personal Tax:									
Gross U.S. Collections (Net of EIC)			645	676	707	739	773	809	846
Cover-Over to P.R.			[1] 482	[1] 666	[1] 168				
Net U.S. Collections			163	10	539	739	773	809	846
Corporate Tax:									
Gross U.S. Collections			249	427	448	471	495	519	545
Cover-Over to P.R.			[1] 249	[1] 427	[1] 174				
Net U.S. Collections			0	0	274	471	495	519	545
Customs Duties			[1] 97	[1] 134	[1] 141	[1] 148	[1] 155	163	171
Rum Excise Tax		[1] 188	[1] 252	[1] 255	[1] 257	[1] 260	[1] 262	265	268
INDEPENDENCE:									
Eliminate Sec. 936 [3]	45	1501	2579	2738	2876	3095	3327	3555	3816
Rum Excise Tax [3]		188	252	255	257	260	262	265	268

[1] Taxes subject to cover-over to Puerto Rico in years designated.

[2] Reflects 1/1/92 extension of Federal excise taxes to Puerto Rico.

[3] Assuming proclamation of independence occurs on 1/1/93.

APPENDIX II.—TECHNICAL ISSUES FOR SUBSEQUENT TRANSITIONAL LEGISLATION

The following discussion identifies some of the technical issues that could be presented by the transition from Puerto Rico's current tax system to the systems contemplated by Senate Bill 712 under the statehood and independence options. This list is not exhaustive and many additional issues will certainly arise as detailed transition mechanisms are developed. As discussed at the outset of this testimony, the Administration believes that technical details, such as the issues described below, should not be addressed by Congress as part of S. 712. To the contrary, we support the approach of the current bill under which Congress retains full authority to develop appropriate transitional rules through subsequent legislation after Puerto Rico has chosen its future political status.

I. Statehood option

A. Domestication of Puerto Rican Corporations

1. Potential Tax upon Domestication.—Upon extension of the Federal tax system to the new State of Puerto Rico, corporations created or organized in Puerto Rico would be treated as "domestic" United States taxpayers. This transition raises many issues concerning how the prior history of the corporation will affect its future U.S. tax liability. For example, the change from a foreign to domestic corporation could be treated as an inbound reorganization triggering the provisions of Code section 367, which could result in an immediate imposition of tax. Alternatively, the domestic conversion could be treated as a nonrecognition event with a carry-over of the corporation's tax attributes described in Code section 381 (e.g., loss carryovers, earnings and profits, and accounting methods).

2. Distributions after "Tax-free" Domestication.—If the domestication of a Puerto Rican corporation is deemed to be a nonrecognition event for U.S. tax purposes, Congress might treat distributions of pre-effective date earnings and profits of a Puerto Rican corporation as if they were distributions from a foreign corporation—*i.e.*, restrict or eliminate the dividends received deduction, while allowing an indirect foreign tax credit for such distributions under Code section 902. Classifying and tracking these prior earnings could involve significant administrative burdens. Nevertheless, assuming Congress rejects the upfront payment of tax under Code section 367, this system would impose an appropriate amount of shareholder level tax on distributions to U.S. taxpayers of earnings and profits which were not subject to corporate tax when accumulated in the "foreign" corporation.

3. Additional Effects of Prior Earnings.—If Congress retains the "foreign" character of earnings and profits accumulated before the effective date, several additional consequences could follow. Investment of such earnings in United States property could be subject to tax pursuant to the rules of Code section 956. To the extent Code section 1248 would have applied to sales of the corporation's stock if the corporation had been a foreign corporation, gains from such sales could be treated as a dividend. Moreover, the Puerto Rican corporation might be subjected to the branch profits tax to the extent it reduced its U.S. branch's investment of pre-effective date earnings and profits in United States assets.

4. Other Attributes of Domestic Status.—The domestication of Puerto Rican corporations also presents issues of extending other tax attributes applicable to certain U.S. corporations. For example, the change could result in a Puerto Rican corporation becoming eligible for the first time to join in the consolidated return of its U.S. affiliated group, with corresponding questions about its ability to use accumulated losses against the income of such a group. In addition, the Puerto Rican corporation could become eligible for the first time to be treated as a small business ("S") corporation as defined in Code section 1361, with the effect of eliminating its corporate tax liability altogether. If the Puerto Rican corporation had been a controlled foreign corporation under Subpart F of the Code, it would presumably shed that status, although the impact of such a change on matters such as its section 959 "previously taxed income" account would have to be addressed.

B. Phase-Out of Section 936

1. Source of Income Rules.—Section 936 benefits currently extend to certain business and investment income from sources outside of the United States. Upon the extension of the Federal tax system to Puerto Rico under statehood, income from Puerto Rican sources would fail this source test. Thus, an adjustment to the source rules would be required to continue the benefits of section 936 with respect to Puerto Rican source income during the phase-out period.

2. Effects of Puerto Rican Tax Payments.—As of the effective date, Puerto Rican taxes would presumably be deductible as state taxes and will no longer generate foreign tax credits. Under Code section 936(c), however, no credit or deduction is permitted with respect to Puerto Rican taxes on income taken into account under section 936. Consideration could be given to allowing the deduction of Puerto Rican state tax payments during the phase-out period to the extent they were allocable to the portion of Puerto Rican income no longer eligible for a section 936 credit. For example, 20% of such taxes could be deductible in 1994, 40% in 1995, etc.

3. Effects of Continued Status of Electing Corporations.—Under current law, corporations electing the benefits of section 936 are subject to several corollary effects. For example, such corporations are considered to be part of the U.S. affiliated group for purposes of the 100% dividends received deduction and the allocation and apportionment of certain expenses between foreign and domestic sources under Code section 864(e). However, such corporations are not eligible to file a consolidated return with their U.S. affiliates. In addition, recipients of dividends from a section 936 corporation may be subject to increased alternative minimum tax liability under Code section 56. In developing subsequent transitional rules, Congress should consider the extent to which these provisions will continue to apply during the phase-out period.

4. Revocation of Section 936 Status.—Under current section 936(e), a revocation of any section 936 election which has not been in effect for ten taxable years requires the consent of the Secretary of the Treasury. Depending on the resolution of the above issues, many corporations may determine that the section 936 credit no longer generates overall benefits when compared to nonelecting status, particularly in the later phase-out period. Accordingly, Congress should also consider whether the revocation procedures under current law will be modified during the phase-out period.

C. Statehood Grants and Assistance

1. Measurement of Taxes Subject to Cover-over.—Under the statehood option, revenues derived from the application of U.S. internal revenue laws in 1994 and 1995 within the State of Puerto Rico will be covered over to the Puerto Rican Treasury. As noted in the above testimony, the current bill language should be clarified to specify the taxes to which this provision is intended to refer and whether it applies to the additional revenues from the phase-out of section 936 in 1994 and 1995.

In subsequent transitional rules, Congress will also need to consider how these grant provisions could best be implemented. With respect to measuring the amount of Federal income taxes that would be covered over to Puerto Rico, a number of different approaches and combinations thereof are conceivable. For example, the cover-over could be equal to the amount of Federal income taxes collected on Puerto Rican source income of all U.S. taxpayers. This would require all U.S. taxpayers to report separately the amount of their Puerto Rican source income and their other income, and to allocate an appropriate amount of deductions to their Puerto Rican source income in order to determine the amount of their Federal tax liability attributable to that income.

Alternatively, or in combination with that approach, the cover-over could include the amount of Federal income taxes collected on the worldwide income of Puerto Rican residents. For purposes of this alternative, Puerto Rican "residents" could be deemed to mean individuals resident in Puerto Rico and Puerto Rican corporations. This alternative would require individuals to report their status as residents of Puerto Rico under whatever residency standard would be established for that purpose. The calculation of the separate Federal tax liability of a Puerto Rican corporation could be difficult where, for example, that corporation is part of a U.S. consolidated group.

To the extent that either of these approaches may be applied in a manner which requires a determination of the excess in Federal tax liability over what it would have been without statehood, affected taxpayers could face substantially more burdensome reporting requirements.

2. Additional Concerns with Cover-Over Mechanism.—The use of a cover-over of Federal tax revenues after Puerto Rican statehood raises several additional concerns. First, Congress has stated its strong reservations with the cover-over system on the basis of equity relative to state governments. This Committee in 1984 expressed the view that the practice should not be expanded without a thorough examination of that issue. S. Prt. 98-169, I-1000.

Moreover, the timing of the payment to Puerto Rico raises significant administrative problems under any cover-over system. The grant could be based on the amount of tax reported or collected for a given year. Neither figure can be finally determined until well after the year in question, yet Puerto Rico's needs will presumably be greater during the early part of the transition period. Advanced payments of the estimated cover-over might be made, but this would require subsequent reconciliation of the corrected amount and possible collection from Puerto Rico of prior overpayments. In short, tying the amount of this grant directly to the revenues collected by (or reported to) the IRS creates a source of continuing controversy which could be counter to the interests of both governments.

3. Alternatives to the Cover-Over System.—The above concerns could be resolved by substituting for the cover-over mechanism a series of direct grants, perhaps keyed to an estimate of the same Federal revenues to which the current provisions are intended to apply. This method would meet Puerto Rico's transition requirements more directly and efficiently while eliminating the significant administrative burden of measuring and transferring the appropriate amounts under a cover-over system. Thus we would recommend clarification in the current bill that Congress retains full authority to develop flexible mechanisms in subsequent legislation for meeting its grant and assistance obligations.

II. Independence option

Relief of Double Filing Burdens.—Under the independence option, Puerto Rico will maintain its own separate system of taxation. However, assuming that current Code section 933 is repealed as of the date of independence, all Puerto Ricans who are U.S. citizens will remain subject to Federal tax on their worldwide income. Many such taxpayers will owe no U.S. income tax, either because of the exclusion for foreign earned income under Code section 911 or due to offsetting credits for the foreign taxes paid to Puerto Rico. Under current law, however, a U.S. return must be filed to claim foreign tax credits or the section 911 exclusion. As part of its transitional rules, Congress should consider adopting some form of simplified procedure to alleviate this double return filing requirement in appropriate cases.

PREPARED STATEMENT OF RAFAEL HERNANDEZ-COLON

Mr. Chairman and distinguished Members of the Committee: I am here today to address an issue of vital importance to both Puerto Rico and the United States. Sometime during the summer of 1991, the people of Puerto Rico—three-and-one-half million U.S. citizens—are going to exercise their right to self-determination, setting the course of their future political relationship with the United States. They hopefully will be granted the opportunity to choose among three clearly defined and balanced status options: to improve their association to the United States through either enhanced Commonwealth, to become a state, or to sever all ties to the U.S. through independence. That momentous choice sealing the political destiny of a people, once made, will be irreversible, binding and self-executing.

In order for the decision to rest with the people of Puerto Rico, the U.S. Congress has to present them three balanced options. If the options are unbalanced—if Congress loads the choices in a way that steers the Puerto Rican people to select a particular outcome—it is Congress which will have made the choice, not the people. Balanced options are crucial if the people of Puerto Rico are to effectively exercise their right to self-determination and assure the legitimacy and integrity of the referendum process.

Mr. Chairman and Members of the committee, unfortunately the status referendum bill, S. 712, as narrowly reported by the Energy and Natural Resources Committee, is not balanced among the options. The most fundamental imbalance arises out of the fact that while the statehood option was granted parity in all Federal social programs, the commonwealth was denied such parity in all requests made before the Energy Committee. The cash benefits arising from parity under statehood creates a constituency for statehood of about half of the electorate and in effect will determine the outcome of the referendum. This has been measured by nationally reputable polling firms. For the first time in history, statehood has commanded a lead in Puerto Rico as a direct effect of the bill reported by the Energy Committee.

That Committee, however, expressly deferred to and requested the independent determination and consideration of this Committee on these social programs and on issues of tax and trade, knowing that your committee has the appropriate jurisdiction and expertise with respect to these matters.

It might be useful at the outset of this presentation for me to describe the current fiscal relationship between the U.S. and the Commonwealth. In order to provide for self-government in Puerto Rico, Congress provided in 1917 that Puerto Rico would be fiscally autonomous. The nature of this relationship sometimes gives rise to the assumption that Puerto Rico pays no taxes yet has substantial Federal benefits. This assumption is incorrect, for several reasons.

Mr. Chairman, Puerto Ricans pay *much higher* local taxes than is true in any state in the Union. Although tax reform measures have recently lowered rates, the top marginal personal income tax rates in Puerto Rico is still 41 percent. This is far higher than any state and even higher than the marginal Federal rate. At every level of income, Puerto Rico's personal tax rate exceeds the U.S. income tax rate, both in marginal and average terms. For example, a taxpayer earning $50,000 in Puerto Rico *pays more taxes* than a person earning the same amount in a large U.S. city would pay in *both Federal and state taxes.*

In addition, although individual and corporate citizens of Puerto Rico do not pay U.S. Income taxes, we *do* pay Federal Social Security (or FICA) taxes, unemployment insurance and Medicare taxes, totalling approximately $1.6 billion a year.

Some Federal programs treat Puerto Rico for funding purposes as a state; others do not. Puerto Rico participates fully in Social Security and Medicare. However, Puerto Rico is given a limited block grant in lieu of participation in the Food Stamps program, and its citizens receive a lower level of benefits than other U.S. citizens under ABDA, Medicaid and other programs.

Mr. Chairman, we believe that the right to participate in the minimal safety net programs is a basic individual right of U.S. citizenship and should not depend upon the accident of geography. Non-U.S. citizens residing in 50 states are generally eligible for full assistance under these programs. In order to be given a fair option between statehood and commonwealth, U.S. citizens in Puerto Rico must not have to choose one over the other so as to be provided with this safety net.

The extension of the full benefits of the social programs to the needy in Puerto Rico must run parallel with the sustainable development of the Puerto Rican economy. The ultimate goal of Federal and Puerto Rican policy must be jobs, good jobs, permanent jobs to enhance our standard of living and lessen dependency on the social programs.

In this regard, this Committee is well aware of the crucial importance of Section 936 of the Internal Revenue Code to Puerto Rico's economic development. Mr. Chairman, I wish to emphasize that this is not just another provision of the tax code, but rather *the very foundation of the Puerto Rican economy. Statehood would inevitably destroy that foundation.*

S. 712 provides no substitute for 936. It takes the motor out of our economy and does not provide any means to keep it going. It merely provides a transition, a phasing out of 936 and even this is done in an unconstitutional manner. You will hear today a discussion of this serious matter by eminent constitutional scholar Laurence Tribe of the Harvard Law School. It is his judgment that the 936 transition under S. 712 does not pass constitutional muster under the Tax Uniformity Clause, because it permits under Puerto Rican statehood a continuation of tax benefits not provided to other states. For Congress to promise a deferral of tax burdens which cannot be constitutionally honored would be most serious.

Furthermore, in considering the future of our economy under statehood, it is imperative to examine the dynamic effects of the imposition of Federal taxes. The political status of Puerto Rico, and its economic future, is no ordinary tax issue, where the assumption of no change in economic behavior is appropriate.

The island of Puerto Rico, while possessing extraordinary God-given beauty, is also, in terms of economic development, burdened with inherent disadvantages. These include location, lack of natural resources, small size, lack of arable land, population density, and the need to pay higher wages than in competitive locations. Section 936, unavailable under statehood, has been the principal tool available to offset these disadvantages.

With the critical help of this tax provision, we have created entirely new manufacturing and service sectors for the Island economy, now accounting, directly or indirectly, for 300,000 jobs—fully half of our Island's private sector labor force. With this section we are now making a significant contribution through twin plant projects in countries within the Caribbean Basin Initiative. Formerly the poorest area of Latin America, we have developed into the most prosperous and we are also helping our neighboring countries. But we still have far to go, as evidenced by our average income today being only one-half that of the lowest-ranking state.

Clearly the reason why companies have established operations in Puerto Rico is that we have been able to offer tax advantages which make possible the profitability of these enterprises in the difficult environment I have described.

Mr. Chairman, in a global economy, the reality is that an additional layer of Federal taxation and elimination of Section 936 will cause these companies to rapidly relocate their operations outside the United States, to areas that already afford similar tax benefit programs. The disastrous effect on employment of this industrial exodus will in turn result in increased social costs and decimation of the local tax base. When added to existing levels of poverty on the Island, this will tragically and inevitably require extraordinary new Federal Government expenditures to deal with a condition of massive dependency.

As I said at the outset, S. 712, the Energy Committee bill, is defective in that is creates an imbalance in favor of the statehood option. It does so by immediately granting full Federal welfare benefits virtually across the board, while at the same time excessively deferring Federal tax obligations and retaining certain unique tax benefits of Commonwealth. In fact, this front-end loading in favor of statehood has been characterized by statehooders as an economic bonanza. On a long-term basis this is an illusion. But short term, and for electoral purposes it works wonders.

To be specific, under S. 712, statehood would occur in 1992 with full welfare benefits in that year except for SSI, which would be phased in over two years. Federal income taxes would not apply in 1992 and 1993, and all such revenues therefrom would be paid over to the state government for the next two years (1994 & 1995). The phase-out of Section 936 would occur over a seven-year period. Moreover, all U.S. excise taxes collected in Puerto Rico would be paid over to the state government along with customs duties on imports into Puerto Rico and U.S. excise taxes on Puerto Rican products shipped to the mainland.

This formulation obscures the true costs of statehood from the electorate. It camouflages, for them, the disastrous long-term economic consequences of statehood while spotlighting the prospect of *immediate* and dramatically higher welfare benefits and all of this purports to be revenue neutral over a five year period at the end of which it would allegedly be revenue positive for the U.S. Treasury.

Above all, it is imperative that the status referendum should not be decided on the basis of which option can deliver the basis necessities of life to the neediest citizens of Puerto Rico. This referendum has profound implications not only for Puerto Rico but for the United States. The options presented must be balanced and their consequences must be fully understood by the electorate. This is essential to avoid economic hardship and a backlash of political resentment from unfulfilled hopes and expectations.

I cannot emphasize too much the fiscal impact of statehood on the Puerto Rican government and the taxpayers who support it. We are analyzing the question carefully and will provide the results to the Finance Committee. At this point, however, I am confident in saying that—short of massive Federal transfers over and above individually targeted entitlement program there is no way for a statehood government to reduce local taxes. To do so would cause huge public employee layoffs and a drastic reduction in services. This is confirmed by the CBO analysis of September 6, 1989, which shows only a small net overlap between full extension of Federal programs to Puerto Rico and present programs and services of our government. This would create the necessity for ruinous business taxes and the highest personal taxes in the United States—striking at the heart of our jobs creation efforts and punishing our fragile middle class.

Mr. Chairman, I am aware of the expertise that exists in your staff, and on that of the Joint Tax Committee and Congressional Budget Office, to analyze both the tax and expenditure issues in this regard. In addition, we have commissioned KPMG Peat Marwick to also undertake a most sophisticated and thorough economic analysis.

Any such analysis has to address the following key questions: With the imposition of Federal taxes, how many companies will relocate and how many thousands of jobs will be lost? What are the effects on the economic growth of the economy, and the cost and magnitude of social programs? What will replace Puerto Rico's fiscal autonomy as the economic development tool?

In closing, Mr. Chairman, may I express again my appreciation for this opportunity to appear before your Committee, particularly in view of the inordinate demands being placed on this Committee and its Chairman in the closing days of this session. I am very much aware, Mr. Chairman, of your long personal experience with Puerto Rico and its economy, dating back to your earlier distinguished service in the U.S. House of Representatives nearly 40 years ago. It is fortunate indeed that the consideration of these crucial and complex matters is in the hands of someone with your perspective and background.

The wisdom of this Committee's deliberations will play a great part in determining how three and a half million of your fellow Americans will live in the future. Ultimately, it will also determine whether the relationship of the U.S. and Puerto Rico, in whatever form, can continue to be of great mutual benefit and cultural enrichment.

I would be pleased to respond to any questions that the Committee may have.

PREPARED STATEMENT OF MICHAEL J. MCKEE

[November 14, 1989]

I am Michael McKee, a Principal and Managing Director of Quick, Finan & Associates, appearing today on behalf of the statehood party of Puerto Rico. I thank the Senate Committee on Finance for consenting to hear our views on the tax and economic implications of admitting Puerto Rico into the union of states.

Previously I served as a Senior Staff Economist of the President's Council of Economic Advisers (during both the Carter and Reagan Administrations) and in the U.S. Treasury's Office of Tax Analysis, as well as at the Organization for Economic Cooperation and Development in Paris. For more than a decade I have specialized in analyzing structural adjustment issues—that is, how shifts in taxes, regulations, development policies and other actions that change the underlying structure (not just the margins) of the economy affect economic growth and performance.

LIMITATIONS OF CONVENTIONAL TAX ANALYSIS

My colleagues on this panel are eminent tax experts, and I appreciate the opportunity to discuss with them the issues of tax policy and the future of the Puerto Rico economy. Before I discuss the key tax issues, I believe it is important to put these issues into a broad policy context, because a broader perspective reveals where it is appropriate to apply conventional tax analysis in assessing the issues at hand—

and where are the appropriate limits on such analysis ar[illegible] the tax experts that apply it.

First, the primary issue of the Constitutional status of Puerto Rico is not fundamentally economic, but one of self-determination and constitutional rights. A secondary, but basic econcmic, question is which regime—statehood, commonwealth or independence—provides the best economic potential for:

(1) the Puerto Rico economy and incomes of Puerto Ricans;
(2) the U.S. economy; and, finally,
(3) the U.S. Treasury.

The answer to this question has tax elements and demands tax expertise, but it also requires addressing a far broader set of structural reform issues that must draw insights from development economics, business location in theory and practice, labor market economics, and fiscal policy in an open island economy.

For the strict purpose of this panel discussion, we can focus on two tax-related questions. First, what are the implications for the Puerto Rico and U.S. economies, and for the U.S. Treasury of continuing Section 936 and the commonwealth? Second, what are the implications of moving away from the special tax benefits of Section 936 in the context of commonwealth and moving toward a more balanced tax, expenditure and economic environment under statehood?

One must beware of false precision in answering such questions. We are being asked to predict changes associated with fundamental restructuring of the economy. Conventional tax expenditure extrapolations and budget projections are misleading, because they invariably make simplified assumptions on future economic growth trends that do not reflect major structural changes and changes in economic behavior.

Big quantitative models also do not work, because they, too, are based on the historical structural relationships. Yet, these big models continue to be applied—sometimes generating results that clearly exceed the bounds of credibility. Do you believe, for example, the forecasts of one recent (January 1989) study that repealing Section 936 would lead to the loss of, among others:

- 34 leather manufacturing jobs in Texas,
- 65 stone, clay and glass-making jobs in New York, and
- 88 wholesale and retail trade positions in Hawaii?

Credible, comprehensive structural analyses must dig deeper into the underlying structure of the markets for labor, capital, and goods and services. They can point to directions associated with policy changes, as well as to the key factors that will affect the changes and the potential associated with such changes—but not to precise trends or scenarios. But, this is an acceptable level of economic detail for this exercise. Economic viability is a prerequisite, but the vote on Puerto Rico's self-determination should not ultimately turn on artificially precise economic numbers.

We can show with certainty that there are many factors (more than previous studies sponsored by the 936 companies would have you believe) associated with statehood that offset the losses and disruptions associated with scenarios for phasing out 936. Taking all factors into account, it is clear that even the worst possible short-term economic costs (cost projected by the defenders of Section 936) associated with ending Section 936 and phasing in a more balanced statehood economy are simply not great enough to deny to the residents of Puerto Rico their fundamental constitutional rights. It is equally clear that Puerto Rico's long-term economic possibilities under statehood exceed those associated with continuing commonwealth.

As I have said, unlike many other issues addressed by this Committee, this is fundamentally not a numbers issue. We can—and will in the future—produce much economic detail and analysis on the questions under review. But, let me tell my views today with as few numbers as I can.

STATEHOOD WILL KEEP MANY COMPANIES AND ATTRACT NEW ONES

Federal tax incentives—grouped here under the heading of Section 936—have been very good for the Puerto Rico economy. Section 936 historically was an important engine of economic development on the island:

- drawing many companies and entrepreneurs to the island,
- generating high-paying jobs,
- developing skills and experience,
- attracting capital,
- helping to improve the educational system and build the island's infrastructure, and

- boosting the incomes of many island residents.

For these benefits one must thank the U.S. Congress and the companies that have been part of this development.

What of the future? What would happen if the Federal tax incentives continue to be decreased and eventually end? What would be the reactions of the current Section 936 companies and of other companies considering location on Puerto Rico without these generous tax benefits?

Two kinds of companies have come to the island and have taken advantage of Section 936: those that may have reason to leave if Section 936 were eliminated, and those that will stay with or without the 936 tax benefits. These companies differ in many ways, but they have one common denominator: good tax advisers.

Consider first the companies that will stay even if 936 is phased out. They are companies that have come to Puerto Rico and have learned about its economic and strategic advantages. They belong in Puerto Rico for real economic reasons, not artificial tax advantages. They will stay and flourish.

Initially, however, they needed good tax advisers to find the commonwealth of Puerto Rico. Recently, we reviewed the treatment of Puerto Rico by business location experts, international commercial organizations, and the popular press. Is the commonwealth of Puerto Rico part of the U.S.? A foreign country? Something else? We found that virtually all sources regard the United States as being the 50 states and the District of Columbia—Puerto Rico is a foreign location if it has any status at all. Indeed, we sometimes had considerable trouble locating Puerto Rico as either U.S. or foreign. For example:

- *The Places Rated Almanac*[1] *bills itself as "Your guide to finding the best places to live in America," and is one of a number of such reference guides that assist individuals and businesses in making location decisions. It ranks locations throughout all the United States on a number of dimensions concerning the quality of living. Puerto Rico is not mentioned. Similarly, most other such rankings of U.S. cities ignore Puerto Rico.*
- The Washington offices of the *American Automobile Association*—a key source of travel information, but also a quintessential representation of American's perceptions of America—contained none of the organization's panoply of maps, triptiks, and tour guides for Puerto Rico. Yet the organization said it had such information for the United States, Canada, and Mexico. The *only* information on Puerto Rico was to be found in AAA's commercial travel agency—ten pages in an AAA travel guide entitled *Bahamas, Bermuda, Caribbean.*

If Puerto Rico were a state, it would not have to rely on astute tax advisers to overcome these and other obstacles of ignorance. U.S. companies, U.S. tourists and others could find it in a conventional search of the states and could judge for themselves its advantages.

Puerto Rico's natural advantages begin with an inexpensive, skilled labor force, along with developed infrastructure and capital stock. These are the legacies of Section 936 development—legacies that would not leave if Section 936 is removed. In addition, the island has a hospitable climate, especially for tourism, and Hawaii's success attracting investment in this area following statehood is encouraging. Puerto Rico's climate and soil conditions are also very favorable for modern agriculture, and once again post-statehood investment in Hawaii is encouraging. We also believe that Puerto Rico's "biculturalism"—its Hispanic culture alongside the long-term ties with the mainland—is a significant asset to businesses operating in both Latin America and the U.S. And if the island achieves statehood, its geographic location would help attract investment from both Latin American businesses entering the U.S. market and mainland firms looking south.

Further, statehood would remove major obstacles to a Puerto Rico location for companies in foreign countries. Under the current commonwealth regime, foreign companies not only face the distorted labor and capital markets caused by 936, but they are effectively precluded from locating on the island because Puerto Rico is not included in the web of international tax treaties with the U.S.

Sustainable economic growth ultimately rests on native resources, talent and initiative, and statehood will not directly enhance or diminish these factors. But statehood would encourage business to exploit them, by guaranteeing to outside investors that the legal protection and financial guarantees of the Federal government and regulation will never be withdrawn. Once this is established, the island's natural advantages would attract significant new investment.

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[1] Boyer, Richard, David Savageau, *Places Rated Almanac* (Prentice Hall, New York, 1989)

DISLOCATIONS CAUSED BY COMPANIES LEAVING CAN BE MINIMIZED

Although the end of Section 936 would certainly unsettle the affected firms and some would leave, there is no evidence that it would cripple the island's economy. Section 936 firms would not abandon their capital investments on the island over night. They would phase out their operations over time. Moreover, their legacy of manufacturing and distribution facilities, trained labor and other resources developed on the island can be exploited by other manufacturing companies and other sectors that would grow more vigorously.

A study prepared for proponents of Section 936 predicts that the island's economy would continue to expand at about 2.4 percent a year with repeal of the tax incentive—nearly the same rate projected for the U.S. That is, those who have every reason to show the most pessimistic scenarios concede that removal of Section 936 would not destroy the fundamental viability of Puerto Rico's economy. And, it is especially important to note that their study assumed immediate termination of the tax incentives with no transition or offsetting impacts from other policies.

For companies that do go, new investment will be needed to replace them. New companies will come—companies investing for fundamental economic reasons rather than tax-driven gains. But, it will require several years to "spread the word," change strategic plans, shift location decisions, and realize the investment potential to facilitate the structural shift to a more balanced economy. Thus, to reduce the disruptions to Puerto Rico's economy (and to the 936 companies), it would be appropriate to adopt a set of transition policies—phasing out Section 936 benefits and/or replacing them with less costly programs. Balancing the need for a long transition period on the island against Federal budget demands and requirements of fiscal prudence for the entire nation, I suggest the Committee consider a phase out of 10 to 15 years.

CONCLUSION

In conclusion, there is great potential for the island economy of Puerto Rico. Under commonwealth that potential can be only partially realized—and then only with the continuation of costly Federal tax benefits. Section 936 has been under criticism for some time. It may or may not have been the best use of Federal resources in the past. But it did work to "bootstrap" the economy to its current level of development. Today, however, Section 936—especially in the commonwealth environment—may not be the best development policy for the future. In fact, I believe there is a clearly superior alternative: Statehood, and its balanced tax and development policies, will allow a more natural and stable environment for the Puerto Rico economy to meet its full potential.

Prepared Statement of Michael J. McKee

[November 15, 1989]

I am Michael McKee, a Principal and Managing Director of Quick, Finan & Associates, appearing again today on behalf of the statehood party of Puerto Rico. I thank the Senate Committee on Finance for consenting to hear our views on the economic and social welfare implications of admitting Puerto Rico into the union of states.

Previously I served as a Senior Staff Economist for the President's Council of Economic Advisers and the U.S. Treasury's Office of Tax Analysis, as well as at the Organization for Economic Cooperation and Development in Paris. For more than a decade I have specialized in analyzing structural adjustment issues—that is, how shifts in taxes, social programs, regulations, development policies and other actions that change the underlying structure of the economy affect economic growth and performance.

POSING THE QUESTION

The matter at hand is not fundamentally economic, but one of constitutional rights: whether the U.S. citizens living in the commonwealth will be allowed to determine the character of their political union.

Often in hearings like this one, economists are called upon to deliver some numbers—year-by-year estimates of how many recipients would enter each program and how much spending would be required, before and after certain policy changes. On this score, current estimates show that after full phase-in, statehood provides a net surplus to the Federal fisc relative to continued commonwealth. Such deficits as occur in the earlier years are a function of the chosen transition policies.

In considering the economic and social implications of statehood for Puerto Rico, and especially the associated changes in welfare benefits, two rather different questions are paramount.

- As raised by Senator Moynihan and others, would the expansion of benefits create significant economic incentives against work and help to create a permanent welfare state?
- How will the welfare policy shifts and all other changes associated with statehood affect the island's future economic performance—which, in turn, determines the long-term economic environment in which the social programs operate?

These most critical economic questions cannot be accurately answered with budget estimates. They require knowledge of the probable shifts in incentives, in underlying market structure and in economic behavior.

My testimony today will address the two economic questions above, primarily in nonquantitative terms. I conclude that:

- The increase in Federal social-welfare program support under statehood would not impair the work culture required for vigorous economic growth in Puerto Rico; and
- statehood, even when tied to the elimination of Section 936 tax incentives, is the best environment for maximizing the long-term economic potential of the island and spurring sustained economic development.

THE STATE OF PUERTO RICO WOULD NOT BE A WELFARE STATE

Some opponents of self-determination have argued that as a state, Puerto Rico's relatively low income and high unemployment would channel too much Federal money to the island. This is not an economic argument, and we leave to others the political and legal debate over whether the Federal Government should vary its social-welfare support, according to whether an American citizen lives in Puerto Rico.

However, there is a related question, one raised by Senator Moynihan which should be joined: Given that the people of Puerto Rico are poorer than those of any of the 50 states, at present and on average, would statehood provide such high levels of Federal social-welfare support, as to undermine the work ethic and create an alternate culture of dependency damaging to economic initiative?

Our judgment is that it would not. The reason is that most of the projected increases would be distributed either as rewards for working, or to people who are too ill, or too young, or too old, or too disabled to work. For the remaining benefits that could be characterized as potentially eroding the work ethic, the probable increases per recipient are much smaller than the aggregate figures suggest.

One should not be deceived by the large absolute and relative increases in the aggregate Federal outlays for these welfare programs. These aggregate increases are irrelevant to the question of how the new or enhanced programs affect the inclination of potentially able-bodied adults in Puerto Rico to enter the labor force and become gainfully employed.

This incentive effect is more a function of the change in per capita benefits for those able-bodied adults potentially meeting the new welfare program requirements. Using this as our criterion, we can rule out certain programs or parts of programs from our locus of concern.

First, consider the Earned Income Tax Credit (EITC) program, which supplements the wages of working parents who earn below poverty incomes. Far from discouraging work, the EITC rewards the work ethic by providing more support for more work.

Second, there is Supplementary Security Income (SSI), providing support for elderly, blind and disabled persons who do not receive Social Security. This would be a new program replacing a smaller existing block-grant program. But virtually all who would receive this help cannot support themselves; the persons receiving these forms of help cannot work regardless of the level of assistance. Statehood would also raise AFDC support for poor children. They, too, cannot work; in addition, these recipients already receive assistance under commonwealth programs supported by the Federal government. Moreover, we cannot tell from the aggregate outlay figures, but it appears that most Medicaid funds would be channeled to the SSI recipients and the AFDC children.

Statehood would also provide certain welfare benefits to some able-bodied persons, as in the 50 states. In this category, we count food stamps and the portion of AFDC and Medicaid benefits supporting the parent. Once again, the commonwealth already provides these benefits. It is difficult to derive from the aggregate outlay figures an estimate of per capita increases, but for most programs the probable increases relative to existing benefits—and, more importantly, to total incomes—is not dramatic. Moreover, there is no evidence that they have altered economic initiative among Puerto Ricans.

In this regard, it has been noted that Puerto Rico has low labor force participation. But by broadening the comparison to Latin American countries, we conclude Puerto Rico's low participation rate is primarily a feature of its transition from an agricultural to a modern economy, and we expect that recent increases in participation will continue.

Unemployment is also higher in Puerto Rico than the U.S. average, once again consistent with rapid modernization. There is also a special factor in Puerto Rico's case: The oil shocks of the 1970s and recession of the early-1980s hit Puerto Rico's less diversified economy even harder than they did the mainland's. As in other developed economies, joblessness in Puerto Rico follows the normal pattern of the business cycle. If statehood spurs economic investment, as we expect, natural growth will reduce island unemployment in a permanent way.

Thus, the next important economic questions are about the economic potential of statehood and how Puerto Rico can best manage the transition from commonwealth to statehood. These questions were addressed in more detail in my testimony yesterday and are briefly covered below.

STATEHOOD WILL SPUR ECONOMIC DEVELOPMENT

Sustainable economic growth ultimately rests on native resources, talent and initiative, and statehood will not directly enhance or diminish these factors. But statehood would encourage business to exploit them, by guaranteeing to outside investors that the legal protection and financial guarantees of the Federal government and regulation will never be withdrawn; that the island's status uncertainty is over. Once this is established, the island's natural advantages will attract significant new investment.

Puerto Rico's natural advantages begin with an inexpensive, skilled labor force, along with developed infrastructure and capital stock—in part permanent legacies of past Section 936 development. In addition, the island has a hospitable climate, especially for tourism, and Hawaii's success attracting investment in this area following statehood is encouraging. Puerto Rico's climate and soil conditions are also very favorable for modern agriculture, and once again post-statehood investment in Hawaii is encouraging. We also believe that Puerto Rico's "biculturalism"—its Hispanic culture alongside the long-term ties with the mainland—is also a significant asset to businesses operating in both Latin America and the U.S. And if the island achieves statehood, its geographic location would help attract investment from both Latin American businesses entering the U.S. market and mainland firms looking south, as well as other foreign firms now lacking tax treaty protection.

Although the end of Section 936 would certainly unsettle the affected firms and some would leave, there is no evidence that it would cripple the island's economy. Those firms that would leave with the ending of Section 936 would not abandon their capital investments on the island overnight. They would phase out their operations over time. Moreover, their legacy of manufacturing and distribution facilities, trained labor and other resources developed on the island can be exploited by new manufacturing companies and other sectors that would grow more vigorously.

A study prepared for proponents of Section 936 predicts that the island's economy would continue to expand at about 2.4 percent a year with repeal of the tax incentive—nearly the same rate projected for the U.S. That is, those who have every reason to show the most pessimistic scenarios concede that removal of Section 936 would not destroy the fundamental viability of Puerto Rico's economy. And, it is especially important to note that their study assumed immediate termination of the tax incentives with no transition or offsetting impacts from other policies, including statehood. We believe that, to reduce the disruptions to Puerto Rico's economy (and to the 936 companies), it is appropriate to adopt a generous set of transition policies—phasing out Section 936 benefits and/or replacing them with less costly programs.

In conclusion, there is evidence and reason to believe that Puerto Rico, even without Section 936 will be richer as a state, than as a commonwealth with special tax benefits. Statehood represents the best potential for vigorous economic development for the 3.3 million American citizens living in Puerto Rico. Although we come to this view by analyzing the economic evidence, we cannot be unaware that one of the great ideas underlying the American experiment with liberty is that political self-determination and economic progress thrive together. It is a lesson that we taught the world; one learned most recently by the peoples of Eastern Europe. Economics does not provide guarantees, and like political liberty, the value of economic freedom is based as much on the experience as on the results.

Attachment.

Value of Grants Received by States at Time of Admission and Equivalent Grant for Puerto Rico, Prepared by price Waterhouse

This report analyzes the value of land and money granted to the 50 states at the tide of their admission to the Union. The study converts these values to current dollars and determines an equivalent value of a grant for Puerto Rico should it become a state. Based on this analysis, we conclude that the equivalent value grant for Puerto Rico would be $154 billion. It should be noted that Congress has historically established land and money grants on the basis of each state's facts and circumstances rather than on averages.

In Table I, the value of the land grant received by each state is calculated in 1989 dollars. This calculation involves first valuing all real property for each of the fifty states. For the value of real property, we used the market value of all assessed ordinary real property published by the Bureau of the Census for 1981.[1] This underestimates the value of real property in each state to the extent that some land is not assessed for property tax purposes (e.g., Federal and state-owned land). To arrive at an approximate land value for each state from real property values, we use the benchmark of Manvel [2] that land is 39% of real property values.

These values are inflated from 1981 to 1989 prices using the yearly growth rate of land values over this period. The growth rate in land value is estimated as the sum of the annual inflation rate and the real rate of land appreciation. The CPI inflation rate averaged 4 percent between 1981 and April 1989. The real rate of land appreciation was estimated using a price index of land calculated by Goldsmith for the period from 1949 to 1967.[3]

The value of each state's land grant is estimated by multiplying the value of land for each state by the proportion of the state's land granted by the Federal government. The land grants to the states are based on a 1980 GAO Study.[4] Totaling the land grants for all 50 states and dividing by the summed population of each state at its time of admission to the union gives the average value of land grants per person in the mainland United States of $48,169. By multiplying this value by Puerto Rico's population, we arrive at the equivalent value of Puerto Rico's land grant $153,996 billion.

Table II adds total monetary grants [5] in 1989 prices) to the total value of land grants. The monetary grants are valued at 1989 prices using the CPI. The average value of monetary grants in 1989 dollars per capita based on admission population, was $9. For Puerto Rico this would amount to $29 million based on 1980 Census Population.

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[1] Bureau of the Census, "Taxable Property Values and Assessment - sales Price Ratios," *1982 Census of Governments*, U.S. Department of Commerce, Washington, D.C.: USGPO, February 1984, Table II.

[2] Allen Manvel, "Trends in the Value of Real Estate and Land, 1959, 1966," *Three Land Research Studies*, The National Commission on Urban Problems, Washington, D.C., USGPO, 1968.

[3] Laurits R. Christensen and Dale W. Jorgenson, "The Measurement of US Real Capital Input, 1929-1967," *Review of Income and Wealth*, Dec. 1969, Series 15(4), p. 299.

[4] General Accounting office, "Experiences of Past Territories Can Assist Puerto Rico Status Deliberations," Report to the Congress, GGD-80-26, March 7, 1980.

[5] General Accounting office (1980).

TABLE I -- LAND AND MONETARY GRANTS RECEIVED BY STATES AT TIME OF ADMISSION

State	Year entered union	Land grant (million acres)	Total state land (million acres)	State population: year of admission (million)	State population: 1980 census (million)	State real property value, 1981 (billion)	Value of State land: 1981 prices 1/ (billion)	Value of State land: 1988 prices 2/ (billion)	Value of State land grant 1988 prices 3/: total (billion)	Value of State land grant 1988 prices 3/: per person (thous) 4/
Alabama	1819	5.007	32.678	0.100	3.894	$51.387	$20.046	$37.170	$5.687	$56.867
Alaska	1959	104.560	365.481	0.226	0.401	$13.507	$6.206	$9.771	$2.786	$12.380
Arizona	1912	10.543	72.688	0.204	2.718	$86.219	$34.406	$63.616	$9.250	$45.294
Arkansas	1836	11.937	33.599	0.080	2.286	$43.874	$17.150	$31.810	$11.301	$141.268
California	1850	8.826	100.206	0.093	23.668	$664.113	$337.004	$625.075	$55.040	$591.806
Colorado	1876	4.472	66.486	0.194	2.890	$112.225	$43.798	$81.180	$5.460	$28.088
Connecticut	1788	0.180	3.135	0.238	3.108	$94.200	$36.740	$68.146	$3.913	$16.444
Delaware	1787	0.080	1.260	0.050	0.594	$13.687	$5.291	$9.814	$0.568	$11.360
Florida	1845	24.214	34.721	0.054	9.747	$316.384	$123.004	$228.147	$159.107	[illegible]
Georgia	1788	0.270	37.295	0.083	5.463	$103.401	$40.381	$74.880	$0.542	$6.530
Hawaii	1959	0.000	4.108	0.633	0.965	$47.047	$18.898	$34.894	$0.000	$0.000
Idaho	1890	4.254	52.933	0.089	0.944	$26.183	$10.211	$18.940	$1.522	$17.100
Illinois	1818	6.235	35.795	0.036	11.427	$230.128	$89.250	$172.077	$30.130	$836.944
Indiana	1816	4.041	23.158	0.064	5.490	$96.256	$37.150	$68.836	$12.024	$188.175
Iowa	1846	8.061	35.860	0.150	2.914	$96.334	$37.570	$69.686	$15.665	$104.431
Kansas	1861	7.785	52.611	0.107	2.364	$60.016	$23.406	$43.414	$6.446	$60.114
Kentucky	1792	0.355	25.512	0.074	3.661	$50.816	$19.818	$36.760	$0.511	$6.912
Louisiana	1812	11.441	28.867	0.077	4.206	$66.738	$26.013	$48.382	$19.684	$255.618
Maine	1820	0.210	19.848	0.298	1.125	$24.203	$9.439	$17.506	$0.186	$0.621
Maryland	1788	0.210	6.319	0.320	4.217	$97.101	$37.869	$70.240	$2.334	$7.301
Massachusetts	1788	0.360	5.064	0.379	5.737	$120.387	$46.951	$87.086	$6.189	$16.290
Michigan	1837	12.113	36.492	0.093	9.262	$169.511	$66.109	$122.620	$40.702	$438.188
Minnesota	1858	16.422	51.206	0.150	4.076	$114.008	$44.464	$82.526	$26.468	$176.343
Mississippi	1817	6.098	30.222	0.076	2.521	$36.943	$14.408	$26.724	$5.382	$71.407
Missouri	1821	7.417	44.248	0.067	4.917	$85.989	$33.529	$62.187	$10.424	$155.660
Montana	1889	5.963	93.271	0.143	0.787	$21.471	$8.374	$15.532	$0.993	$6.944
Nebraska	1867	3.458	49.031	0.029	1.569	$46.414	$18.101	$33.575	$2.369	$82.170
Nevada	1864	2.725	70.264	0.016	0.800	$29.424	$11.475	$21.284	$0.826	$50.413
New Hampshire	1788	0.150	5.769	0.142	0.921	$22.019	$8.587	$16.020	$0.414	$2.916
New Jersey	1787	0.210	4.813	0.184	7.365	$170.066	$66.321	$123.013	$5.367	$29.148
New Mexico	1912	12.706	77.766	0.327	1.303	$29.347	$11.445	$21.229	$3.468	$10.607
New York	1788	0.990	30.680	0.340	17.558	$282.374	$110.128	$204.282	$6.591	$19.379
North Carolina	1789	0.270	31.402	0.394	5.880	$117.884	$46.014	$85.346	$0.732	$1.858
North Dakota	1889	3.284	44.452	0.191	0.653	$17.070	$6.657	$12.348	$0.907	$4.747
Ohio	1803	2.750	26.122	0.042	10.798	$219.111	$85.453	$158.400	$16.741	$398.394
Oklahoma	1907	3.095	44.087	1.414	3.025	$70.156	$27.360	$50.748	$3.563	$2.519
Oregon	1859	7.032	61.588	0.052	2.633	$96.994	$37.828	$70.167	$8.009	$152.064
Pennsylvania	1787	0.780	28.804	0.434	11.865	$199.253	$77.709	$144.134	$3.903	$8.994
Rhode Island	1790	0.120	0.677	0.069	0.947	$18.840	$6.568	$12.182	$2.159	$31.373
South Carolina	1788	0.180	19.374	0.249	3.121	$54.738	$21.348	$39.596	$0.368	$1.477
South Dakota	1889	3.435	48.882	0.349	0.691	$21.375	$8.336	$15.462	$1.087	$3.113
Tennessee	1796	0.300	26.728	0.077	4.591	$85.998	$33.539	$62.209	$0.698	$9.037
Texas	1845	0.180	168.218	0.243	14.226	$369.753	$150.834	$279.766	$0.299	$1.234
Utah	1896	7.502	52.697	0.277	1.461	$35.529	$13.858	$25.730	$3.659	$13.220
Vermont	1791	0.150	5.937	0.241	0.511	$12.693	$4.950	$9.182	$0.232	$0.963
Virginia	1788	0.300	25.498	0.692	5.347	$117.338	$45.761	$84.878	$0.999	$1.444
Washington	1889	3.044	42.694	0.357	4.132	$130.041	$50.716	$94.068	$6.707	$18.775
West Virginia	1863	0.150	15.411	0.377	1.950	$26.275	$10.247	$19.007	$0.185	$0.491
Wisconsin	1848	10.180	35.011	0.250	4.706	$106.590	$41.570	$77.104	$22.419	$89.677
Wyoming	1890	4.363	62.343	0.063	0.469	$13.719	$5.350	$9.924	$0.693	$11.077
AVERAGE										$48.169
TOTAL		328.416	2,271.320	10.894	225.898	$5,361.780	$2,091.088	$3,878.548	$524.738	

1/ Estimated as 39% of real property values. This percentage determined by Manvel(1968).

2/ Adjustments to 1988 prices are based on real historic land appreciation of 4.1% (based on data from 1949 to 1987) plus CPI inflation from 1981 to 4/1988

3/ State land values in 1988 prices (estimated from market values of all assessed ordinary real property) times the proportion of the state's land granted

4/ Value of grant in April 1988 dollars divided by population at time of admission into Union

5/ $0.000 means monetary grant was less than $500,000

TABLE II — EQUIVALENT VALUE OF LAND GRANT FOR PUERTO RICO

Current population - 1980 (millions)	3.197
Ave. value of land grant per person in mainland US (thousands)	$48.169
Equivalent value of land grant for Puerto Rico (billions)	$153.996
Average value of land grant + monetary grant per person in US (thousands)	$48.178
Equivalent value of land grant + monetary grant for Puerto Rico (billions)	$154.025

PREPARED STATEMENT OF CAROLYN L. MERCK

Mr. Chairman, my name is Carolyn Merck. I am a legislative analyst with the Congressional Research Service (CRS). The purpose of my testimony today is to describe how welfare programs and recipients might be affected by a change in Puerto Rico's status. My statement is largely drawn from a report CRS prepared last summer at Senator Moynihan's request.

I would like to preface my testimony by saying that I will not address program costs or budget effects, as the Congressional Budget Office is charged with the responsibility of providing such estimates for the Congress.

In order to keep my statement brief, I will discuss only the most significant changes that would occur if Statehood were to be chosen in the referendum. However, most welfare programs would be unaffected by the enhanced Commonwealth option, and, under independence, welfare programs would no longer be the responsibility of the U.S. Government.[1]

If Statehood were to be the outcome of the referendum, the Earned Income Tax Credit (EITC), and the Supplemental Security Income (SSI) and Food Stamp programs would undergo the most significant changes in scope. These programs have federally financed, nationally uniform eligibility and benefit criteria and are generally geared to serve a population whose income is low relative to mainland U.S. incomes. Because incomes in Puerto Rico are far below those of even the poorest state, the eligibility levels for these programs would occur at a point below which a large segment of the Island's population would fall.[2]

EARNED INCOME TAX CREDIT

The Earned Income Tax Credit (EITC) is a refundable tax credit for households with earned income and dependent children. It is not available in Puerto Rico because it is part of the U.S. income tax system. However, upon implementation of the Federal income tax in the State of Puerto Rico, this program would be extended to all working Puerto Rican parents with adjusted gross incomes below $19,340.

Given the distribution of family income in Puerto Rico, a rough estimate shows that in 1979 almost two-thirds of all Puerto Rican families with children would have been eligible for the EITC if it had been available then at today's real dollar levels.

SUPPLEMENTAL SECURITY INCOME

The Supplemental Security Income (SSI) program, which is not available in Puerto Rico, provides federally financed, nationally uniform monthly cash assistance to low-income elderly, blind, and disabled persons.

Instead of SSI, the Commonwealth operates a program of Aid to the Aged, Blind and Disabled (AABD) according to locally determined eligibility and benefit criteria. Federal funds going to Puerto Rico for AABD are subject to an annual cap, and the Commonwealth is required to pay 25 percent of benefit costs.[3]

Under Statehood, SSI would replace the AABD program at 100 percent Federal expense, and the cap on Federal funds would be removed. Income eligibility and maximum benefit levels would increase from $32 monthly (for those with no other income and no shelter costs) to $368 monthly (about $245 if they lived in another's household). A jump of this magnitude undoubtedly would expand the population eligible, increase payments to program participants 8- to 11-fold, and could potentially affect persons other than SSI recipients. The elderly in Puerto Rico tend to live in extended households, and a large increase in the income of one household member might create a work disincentive for other household members.

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[1] Under independence, many issues pertaining to the social security retirement program would have to be resolved by a special transition commission, including credits for work performed under the U.S. system and which nation's program would pay for the benefits according to what formula. At least in the short run, there could be increased costs to the United States if it continued to pay Puerto Rican beneficiaries but no longer collected payroll tax from Puerto Rican workers and employers.

[2] According to 1980 census data, the median family income in the United States was nearly $20,000; in Mississippi, the poorest State, it was $14,600, but in Puerto Rico it was only $6,000. Using the income standard that defines poverty in the States, in 1980, 9.6 percent of families in the United States fell below poverty. In Mississippi about 20 percent of families were poor, and in Puerto Rico 58 percent fell below the U.S. poverty line.

[3] Federal funds for AABD are combined with funding for Aid to Families with Dependent Children (AFDC), emergency assistance, and foster care and adoption assistance. In 1989, Federal funds are capped at $82 million. In 1987, AABD payments in Puerto Rico totaled $17.2 million (Federal plus Puerto Rican funds).

THE FOOD STAMP PROGRAM

Although the Food Stamp program is not under the jurisdiction of this committee, its counterpart, the nutrition assistance program (NAP), is the linchpin of Puerto Rico's welfare system. The NAP provides more money and affects more people in the Commonwealth (about 43 percent of the population) than all other means-tested welfare programs put together.

Statehood would require the extension of the regular Food Stamp program to Puerto Rico with four major consequences:

- Benefits would have to be issued in food stamp coupons rather than cash, requiring implementation of redemption procedures and monitoring of food store operations;
- The number of recipients could increase by 400,000 persons, to well over half the population;
- Benefits to participants would rise significantly, by at least 20 percent; and
- Puerto Rico would lose the very substantial flexibility it now has to design its major cash welfare program as it sees fit, without the panoply of Federal food stamp rules that States must follow.

Overall, this increase in income to a large segment of the Island's population in the form of coupons earmarked for food could create distortions of uncertain dimensions in food markets and the economy in general.

AID TO FAMILIES WITH DEPENDENT CHILDREN

Puerto Rico decides benefit levels and eligibility criteria for the Aid to Families with Dependent Children (AFDC) program, as do the States. However, unlike the program in the States, funding is subject to a cap, and Puerto Rico is required to pay 25 percent of benefit costs. AFDC covers only about 5 percent of the population and, thus, is much smaller in scope than the NAP or, potentially, the Food Stamp program.

If Puerto Rico were to become a State, the cap on Federal funding would be removed, and the Federal Government's share of benefit costs would rise from 75 percent to 83 percent. However, it is unclear how Puerto Rico would respond to open-ended funding for AFDC at an 83 percent matching rate. By spending somewhat less money, Puerto Rico could maintain existing benefit levels. Because the Food Stamp program would be available to a broader population and would offer higher benefit levels at no cost to Puerto Rico, there would appear to be little reason for Puerto Rico to expand its AFDC program.

MEDICAID

The Medicaid program is available in Puerto Rico under current law, but it functions under vastly different rules from those that prevail in the States. Medicaid funding in Puerto Rico is capped, and the Commonwealth must pay half of program costs. Under Statehood, the cap on Federal funds for Medicaid would be removed, and the Federal share of costs would rise from 50 percent to 83 percent. As a result, Federal spending for Medicaid in Puerto Rico could more than double.

In addition, Puerto Rico would become subject to new requirements for furnishing more extensive coverage to some classes of individuals (pregnant women and infants in families with incomes up to 100 percent of the Federal poverty line), while cutting off coverage to others (persons with incomes over 133⅓ percent of the AFDC payment level).[4] Also, Puerto Rico would no longer be permitted to restrict Medicaid providers to public hospitals and clinics.

CONCLUSION

In conclusion, under the Statehood option for Puerto Rico, a sharp rise in welfare benefits could dramatically reconfigure the outline of the Island's income distribution. While, on the one hand, this could have salutary effects on the living standards of many low-income people, the effect on labor force participation and work disincentives in an economy in which unemployment is already very high (14.5 percent) is an issue of serious concern.[5]

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[4] Puerto Rico provides medical services financed by Medicaid to persons with incomes up to five times the AFDC payment level ($5,700 for a three-person family in 1986).

[5] In 1987 the labor force participation rate (persons age 16 and over) was 44.1 percent: 59.7 percent for males and 30.4 percent for females.

PREPARED STATEMENT OF LINDA G. MORRA

Mr. Chairman and members of the committee: I am pleased to be here today to provide background information for the Committee as it begins its deliberations on the future political status of the Commonwealth of Puerto Rico.

As you begin your work on S. 712, understanding the existing relationships between the Federal Government and Puerto Rico regarding taxes, income security and health care programs, and how the government of Puerto Rico differs from that of the 50 states will provide an important context.

BACKGROUND

Puerto Rico was ceded to the United States by Spain in 1898 and administered as a territory until 1952, when the island became a commonwealth of the United States with its own constitution. The island has about 3.3 million residents, which makes it larger than 26 of the 50 states. Under the provisions of S. 712, the people of Puerto Rico will have an opportunity to decide their future political relationship with the United States in 1991. This bill authorizes a referendum and defines three status options: commonwealth, statehood, and independence.

Unlike the cases of the 37 states admitted to the Union since 1791, this bill's approach to deciding political status is based on transition provisions that would automatically implement the status option that receives a majority of votes cast in the referendum. As a result, the specific provisions contained in this bill are very important. They result in costs and benefits that could accrue to both the Federal Government and the people of Puerto Rico under each of the status options.

I would like to begin my presentation with an overview of the significance of Federal spending, Federal tax policies, and other related influences on Puerto Rico's economy today.

THE FEDERAL FISCAL INFLUENCE IN PUERTO RICO

Federal spending comprises about 30 percent of Puerto Rico's gross product. In the 50 states, the average is about 22 percent. Puerto Rico's gross product was about $18 billion in 1988. Federal spending on the island that fiscal year, for all purposes, was about $6.2 billion. About 38 percent of this—about $2.4 billion—was in grants to the commonwealth or its local governments. This includes welfare assistance, education, highway aid, and customs duties shared with the island. Another 47 percent was for direct payments to individuals, including those for retirement, disability, and veterans' benefits. Most of the remaining 15 percent was for Federal procurement, such as military purchases, and wages of Federal employees on the island, such as postal workers.

In addition to Federal spending, certain tax benefits accrue to both individuals and corporations. Islanders and U.S. corporations doing business in Puerto Rico are, for the most part, exempt from Federal taxes. In a 1987 report, we estimated that, in 1983, the Federal treasury would have received an estimated $2.4 billion if Federal tax laws were extended to Puerto Rico.[1] About 88 percent of this would have resulted from taxing corporations, and the remainder from taxing individuals.

Finally, the Federal Government provided $703 million to Puerto Rico in direct loans, loan guarantees, and insurance in fiscal year 1988. For example, the Federal Government guaranteed $50 million in student loans, $454 million in mortgage insurance, and $9 million in VA home loans.

Given this context, I would now like to discuss several significant Federal programs and laws under which Puerto Rico is currently rated differently than are the 50 states.

CURRENT TREATMENT OF PUERTO RICO IN SELECTED FEDERAL LAWS AND PROGRAMS

Generally, Puerto Rico is treated as a state under most federal laws and programs. The major exceptions are in the tax laws, income support programs, and health care programs. Most of these are under this committee's jurisdiction.

Tax Laws

Puerto Rico is not subject to Federal individual or corporate income tax laws. Since 1919, Puerto Rico has adopted its own tax law. In this respect, it is similar to a foreign country. Two provisions in Federal tax law are designed to encourage industry and improve the Puerto Rican economy. The first is the possessions tax credit, also known as Section 936 of the Internal Revenue Code. The second, Section 7652(a) of the code, governs taxes on shipments to the mainland U.S.

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[1] *Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and American Samoa* (GAO/HRD-87-60, Sept. 15, 1987).

Section 936.—The possessions tax credit is designed to encourage U.S. businesses to invest in Puerto Rico and U.S. possessions. It has the effect of exempting the income U.S. firms earn from business operations and certain financial investments in Puerto Rico from Federal corporate income taxes. According to the Department of the Treasury, in 1983 (which is the most current published data available) 625 corporations in Puerto Rico received benefits equaling $1.6 billion. These companies employed about 89,000 employees. The estimated tax benefit per employee averaged $18,523, or 125 percent of the average compensation per employee. Forty-six percent of the benefits went to pharmaceutical companies, which accounted for about 15 percent of the total employment.

Section 7652(a).—Another important provision of the tax code allows taxes collected under the internal revenue laws on items produced in Puerto Rico and sold in the states (or consumed on the island) to be deposited in the Treasury of Puerto Rico. Puerto Rico received $227 million under this provision in 1987.

Income Support Programs

Of the six largest income support programs, three are applied in the same way as they are in the 50 states, and three are applied differently to Puerto Rico. The three that are applied the same are social security, unemployment insurance, and child nutrition. Those that differ are Adult Assistance (the predecessor program to Supplemental security Income, or SSI) Nutrition Assistance (which is similar to Food stamps) and Aid to Families With Dependent Children (AFDC). For these programs, federal funding is capped and benefits are lower than they are in the 50 states.

Adult Assistance.—Among states, assistance to the needy, aged, blind, and disabled individuals is provided through the SSI program. This program is completely federally funded and administered. Puerto Rico is excluded from participating in this program. Instead, its assistance to these individuals continues through SSI's predecessor adult assistance programs, which are jointly funded by the Federal and Puerto Rican governments, and administered by Puerto Rico. In fiscal year 1989, the Federal share of Puerto Rico's adult assistance programs was $11.9 million. The average monthly payment was $32 plus half of actual shelter costs, compared with the U.S. average under SSI of $362 a month.

Aid to Families with Dependent Children.—AFDC provides cash payments to needy children and their caretakers through state-operated programs that are jointly funded by the state and federal governments. The Federal share is an open-ended match ranging from 50 to 83 percent of total costs, depending on a state's per capita income. However, the Federal share for Puerto Rico is fixed at 75 percent and funding is capped. The Federal share of Puerto Rico's AFDC payments amounted to about $50 million in fiscal year 1988. Its monthly benefit of $90 for a family of three is $28 lower than the lowest maximum payment in the 50 states.

Nutrition Assistance.—Among the states, the Food Stamp program provides Federal open-ended funding for a state-administered program of food assistance. Puerto Rico is excluded from participating in this program. In its place, the Federal government has created a separate Federal Nutrition Assistance program. This grant is not open-ended, like the Food Stamp program; however, as in the states, it is administered by Puerto Rico. A funding ceiling of $937 million was authorized for fiscal year 1990.

Ms. Merck, in her testimony, will discuss the implications of the various political status options for each of these three programs.

Health Care

I would now like to briefly summarize the differences in the two major health care programs, Medicaid and Medicare. In both cases, Federal funding is lower in Puerto Rico.

Medicaid.—Among the states, Medicaid provides health care through state-operated programs that are jointly funded by the state and Federal governments. However in Puerto Rico there is a funding cap, much like in the three income security programs just discussed. A funding ceiling of $79 million is authorized for fiscal year 1990.

Medicare.—In the case of Medicare, Federal cost reimbursements are open-ended, as they are in the 50 states, but the cost reimbursement rate is lower because it is based on the average Puerto Rican hospitalization costs, not the U.S. average, as they are for the 50 states.

Again, Ms. Merck will discuss these in more detail.

GOVERNMENTAL STRUCTURE AND FINANCES

I would now like to turn to several characteristics of Puerto Rico's governmental structures that differ from those of the states and that could be affected by a change in political status. I will then discuss briefly Puerto Rico's financial structure.

First, I would like to note that government (federal, commonwealth, and local) is the largest employer on the island, employing about 201,000 people, or about 23 percent of the total number employed on the island. This is greater than the 7 percent for the United States as a whole. In addition, the Commonwealth operates 52 public corporations.

Governmental Structure

While similar to the states' governmental structure in most respects, Puerto Rico's system of government has two unique characteristics. First, the central government directly provides a number of services that, in the 50 states, local governments provide. And second, the central government owns or controls a number of public corporations. It is not clear how a status change might affect either characteristic.

Role of Local Governments.—Municipalities are the only political subdivisions in Puerto Rico, and they have limited service delivery responsibilities. The great majority of governmental functions are financed and administered by the central government and its public corporations. For example, municipalities share a limited responsibility for education and health, providing services such as school bus and ambulance personnel. Localities raise few of their own resources and depend heavily on Commonwealth and Federal grants for their operating revenues. The Commonwealth provides public education, public health, police, fire, and utility services. Some municipalities augment the Commonwealth police with their own local police forces, and two provide their own electric power because they are too remote from the facilities of the Electric Power Authority.

Public Corporations.—Puerto Rico has 52 public corporations. Puerto Rico relies on public corporations to deliver more kinds of services than are currently provided by similar state authorities, boards, and other quasi-independent state agencies. While some, such as the University of Puerto Rico and the Electric Power Authority, have counterparts in the states, others do not. For example, Puerto Rico's Telephone Authority and Communications Authority operate the island's telephone system. The Electric Power and the Aqueduct and Sewer Authorities provide public utilities. The Sugar Corporation grows sugar cane, buys it from private firms, processes it, and markets it. The Maritime Shipping Authority operates three shipping lines. And the Government Development Bank is the financial advisor and fiscal agent for the Commonwealth government, and makes loans to the public corporations as well as to private enterprises.

In 1987, 11 of the largest of these corporations had net assets of about $5 billion and revenues of about $2.7 billion. While most of these corporations obtained their revenues from charges for services or products, a number of the corporations, such as the Sugar Corporation and the Maritime Shipping Authority, operated with a net loss and were subsidized by the central government.

Under any of the status options, there are no obvious reasons why the current governmental use of public corporations would necessarily change.

Government Finances

The aggregate short-term financial condition of the Commonwealth's central government, its public corporations, and its municipalities shows a surplus. The Commonwealth's 1990 budget projects revenues of about $10.5 billion for 1989 (for the central government, its public corporations, and the municipalities) and expenditures of about $9.8 billion. About 36 percent of these revenues are from the sales of goods and services from the public corporations.

Puerto Rico, however, has a relatively high public debt that was exceeded by only 6 of the 50 states, although much of it is attributable to Puerto Rico's public corporations. In 1987, the public debt was $10.1 billion, of which public corporations comprised about 71 percent. Even excluding Puerto Rico's debt attributable to public corporations, however, the percent of the Commonwealth's and municipalities' debt in relation to the island's gross product is about one-third higher than the average for the 50 states and their localities.

Revenues.—Total revenues for Puerto Rico's central and municipal governments, excluding the public corporations, will be about $4.8 billion in 1989. This is about 26 percent of the island's gross product. For the 50 states, the average is about 18 percent.

The largest share of total aid—24 percent—will be from federal aid. This is nearly twice the average for the 50 states. The other three major components, almost equally divided, are sales, and individual and corporate income taxes. Puerto Rico relies more heavily on individual and corporate income taxes than the states—41 percent of total revenues, as compared to 14 percent for the states and their localities. For example, corporate income taxes account for 22 percent of Puerto Rico's revenues—significantly higher than the 3 percent U.S. average. Conversely, property taxes account for about 6 percent of Puerto Rico's revenues—less than half that of the states and their localities.

The implications of the status option for independence on revenues are not clear. Even though nearly a quarter of the government's revenues are derived from Federal assistance, it is unclear whether it would necessarily lose this support under the independence option. For example, treaties similar to those in the Philippines on base use payments could supplement an independent Puerto Rico's budget. In addition, the current market for the government's and the public corporations' tax-exempt issues could be affected. This could have potentially adverse ramifications on its debt structure, depending on how the banking community perceives the transition from a U.S. commonwealth to an independent nation.

Under the statehood option, the heavy reliance on income taxes, especially corporate income taxes, would probably change because of the imposition of Federal income taxes. This could place pressures for increasing other tax sources. The option of continued commonwealth would probably have very little effect on revenues.

Expenditures.—Excluding the public corporations, the Commonwealth spends about 29 percent less per capita than state and local governments. It tends to spend less on education than the states. Education comprises 23 percent of total spending in Puerto Rico compared with 33 percent for the states. Puerto Rico also spends less on welfare (6 percent vs. 11 percent). But it spends more on housing and community development (8 percent vs. 2 percent), and more on health care and hospitals (11 percent vs. 8 percent).

The independence status option would create new demands for expenditures, potentially in defense, postal, and other services currently provided by the Federal government. Under the statehood option, uncapping Federal benefit programs and imposing federal standards could result in pressure for the Commonwealth to increase its expenditures in the areas of income security and health care as Federal matching programs drive greater expenditures. Under the commonwealth status option, the potential for change is unclear.

Mr. Chairman, this concludes my presentation. I would be happy to answer any questions you may have. Thank you.

Attachment.

[U.S. General Accounting Office: Briefing Notebook for the Committee on Energy and Natural Resources, U.S. Senate, June 1989]

PUERTO RICO: INFORMATION FOR STATUS DELIBERATIONS

SECTION 1.—PUERTO RICO'S HISTORICAL EVOLUTION TOWARD GREATER SELF-GOVERNMENT

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1917 Organic Act Included U.S. Citizenship and Locally Elected Legislature

Many Puerto Ricans voiced disapproval of the first Organic Act because they believed it did not provide as much autonomy as the 1897 Spanish Charter. Consequently, they pressed for greater self-government, such as a totally elected legislature. After sustained attempts (delayed by World War I) revisions were granted in March 1917.

This new Organic Act, known as the Jones Act, marked a major step toward home rule. It included a bill of rights and authorized a popularly elected 19-member Senate as a coequal companion to the 39-member House. The Executive Council was divested of its legislative role, and most of its members were to be appointed by the governor, rather than presidentially appointed. Puerto Rican Supreme Court justices, the governor, and several council members, however, continued to be appointed by the president. Although granting more self-governing powers, the Congress retained the right to nullify any local law. Also, the governor could refer legislation to the president for final disposition if the governor's veto was overridden. This procedure was exercised only three times, all in the 1940s.

The Jones Act also extended U.S. citizenship to Puerto Ricans who desired it. Like the original act, however, the Jones Act did not solve the island's ultimate status. In

1922 the U.S. Supreme Court reaffirmed that these provisions did not incorporate Puerto Rico into the Union. Although recognizing that citizenship was an important factor, the court stated that incorporation depended upon a clear and deliberate action by the Congress.

An Elected Governor—Another Step Toward Greater Self-Government

Although the new Organic Act provided a fully elective legislature, questions concerning the island's ultimate status remained, and requests for increased autonomy continued. For example, Puerto Ricans argued that although they were U.S. citizens subject to the military draft, their participation in national affairs was limited.

Legislation passed in 1947 authorized Puerto Rico to select its own governor and enabled the governor to appoint executive officials. However, like all its predecessors, the act did not determine the island's final status, and the Congress still retained the power to annul legislation.

Greater Home Rule—Constitution Established and Commonwealth Formed

Dissatisfaction with this remaining Federal jurisdiction propelled movements for increased local control. In 1950, the Congress authorized Puerto Rico to organize a constitutional government. This legislation specified that the constitution was to be republican in nature and include a bill of rights. After the populace approved the law, a constitutional convention was held.

Three of the island's four major political parties had delegates elected to the constitutional convention. One party refused to nominate candidates because the convention "did not have the constituent authority necessary to make Puerto Rico a free and independent republic." The constitutional convention met initially on September 17, 1951, and completed its work in February 1952. On February 6, the convention delegates approved a Constitution by 88 to 3.

Following congressional and local approval the Constitution of the Commonwealth of Puerto Rico became effective on July 25, 1952, and certain sections of the organic Act were repealed. Thus, Federal responsibility in purely local matters terminated, and, like states, local executive, legislative, and judicial authority rested with Puerto Rico. Then in 1953, the General Assembly of the United Nations approved a resolution recognizing the new status of Puerto Rico. The United Nations authorized the U.S. to discontinue reporting information on Puerto Rico as a non-self-governing territory. The remaining sections of the Organic Act became the Puerto Rican Federal Relations Act; (the Federal Relations Act and the Commonwealth Constitution are further discussed in section 5).

(This portion of section 1 has been updated from the 1981 GAO report.)

Puerto Rico's Status Before the United Nations

Prior to 1952, the United States submitted information on Puerto Rico's economic, social, and educational conditions to the United Nations, which required nations to submit this information if they administered territories where people had not yet attained self-government. In 1953, however, the United States informed the United Nations that it would cease reporting such information on the grounds that the Puerto Rican government was largely autonomous as a result of its commonwealth status. Since that time however, the United Nations Decolonization Committee has urged the United States to take all necessary measures to transfer total sovereignty to Puerto Rico.

The United States, however, has maintained that a 1953 United Nations resolution, which recognized that Puerto Rico had exercised its right to sovereignty, leaves the United Nations with no jurisdiction in the matter. Recently, a resolution was passed in the United Nations calling for decolonization of all territories by the year 2000. Although Puerto Rico was not mention specifically, the United States was the only country to vote against this measure. Twenty countries abstained and two were absent when the resolution was voted on.

Puerto Ricans Strive to Resolve Status Issue

During the 1950s and 1960s, Puerto Rico began a transformation from an agrarian to an industrial-based society, but economic change came quicker than political change. Several attempts were made during the period to clarify the commonwealth status and expand the island's political powers. For example, in 1959, the Commonwealth legislature submitted a bill for consideration by the Congress to transfer some important powers to Puerto Rico, such as the right to fix its own duty on certain imports, but no action was taken. After a 1963 bill introduced in the Congress to draft a new compact to give Puerto Rico greater autonomy failed, the Congress created the U.S.-Puerto Rico Commission on the Status of Puerto Rico. The commission recommended that the relationship be based on the principle of mutual consent and self-determination through a referendum.

The 1967 Referendum

In July 1967, pursuant to recommendations formulated by the status commission, a referendum was held in Puerto Rico on three political status alternatives: statehood, independence, or continued commonwealth status. Commonwealth status was supported by 60.4 percent of the voters, 39.0 percent favored statehood, and 0.6 percent supported independence.

Post-Referendum Activities

Subsequently, in 1973, an advisory group, appointed by President Richard Nixon and Governor Rafael Hernandez-Colon, explored ways to further develop the commonwealth status and recommended that Puerto Rico be able to:

- —participate in international organizations and make agreements with foreign countries consistent with U.S. policy;
- —set minimum wage rates and environmental protection regulations;
- —take part in establishing immigration quotas;
- —levy, change, or eliminate tariffs on goods imported into the island, consistent with U.S. laws and international obligations;
- —have representation in the U.S. Senate as well as the House of Representatives; and
- —object to certain Federal legislation and have such objections acted upon by the Congress.

These features were embodied in the "Compact of Permanent Union Between Puerto Rico and the United States," a bill introduced in the Congress in 1975. This proposal also called for establishing a U.S.-Puerto Rico commission to study the possibility of transferring Federal functions to the island and instituting a system of contributory payments to the Federal Treasury. After several hearings and amendments, the bill died in committee.

In December 1975, a slightly modified version of the proposed compact was introduced in the House of Representatives, where it died in committee. A Senate version of the compact was also not acted upon.

Other initiatives included a statehood proposal made unilaterally by President Gerald Ford in December 1976. The proposed legislation called for hearings and studies on statehood's effects, a status referendum, and a constitutional convention. In January 1977, a Puerto Rican statehood bill was introduced in the Rouse of Representatives and was referred to the Committee on Interior and Insular Affairs. Though a longtime proponent of statehood, then Governor Carlos Romero-Barcelo did not mention the Ford proposal in his inaugural address on January 2, 1977. Instead, he concentrated primarily on the economic problems facing the island, including high unemployment, which was 21 percent in 1976.

In March 1977, President Jimmy Carter appointed an Interagency Study Group on Puerto Rico to study its economic problems but the report did not discuss status issues. In 1982, President Ronald Reagan reaffirmed the right of the Puerto Rican people to self-determination, and indicated his preference for statehood.

In 1979 the U.S. House of Representatives passed a concurrent resolution reaffirming its commitment to respect and support the right of the people of Puerto Rico to self-determination. More recently, during the 100th Congress, several bills were introduced to provide for self-determination for Puerto Rico but no action was taken.

Current Activities

In the November 1988 general election, all three of the major Puerto Rican political parties, which represent the three alternatives for the ultimate status of Puerto Rico, advocated a resolution of the status issue in the platforms they presented to the electorate. In 1988, Rafael Hernandez-Colon was reelected governor.

In accordance with the platform of his pro-commonwealth Popular Democratic Party, Governor Hernandez-Colon announced in his inaugural address the intention of the government of Puerto Rico to hold a referendum on Puerto Rico's political status. President George Bush, in his State of the Union address in February 1989, reaffirmed the right of self-determination for the 3.3 million residents of Puerto Rico.

In April 1989, as Chairman of the Senate Committee on Energy and Natural Resources, you introduced legislation that would lay the groundwork for referendums on Puerto Rico's political future. This legislation would allow the Puerto Rican people to make a choice between three options—statehood, independence, or an enhanced commonwealth status.

[This section is reprinted from the 1981 GAO report. It has not been updated.]

SECTION 2.—POLITICAL AND LEGAL FRAMEWORKS FOR DECIDING THE STATUS OF THE COMMONWEALTH

Initial Decisionmaking Framework Emanates From Experiences of Past Territories

The fundamental principles to be applied during any status deliberation are well-rooted in American history. The U.S. Constitution grants the Congress broad authority over territories and permits it great flexibility in admitting States or granting independence. Historically, in deliberating and legislating status changes, the Congress has emphasized the traditional principles of democracy, population, and economic capability and adhered to the territories' choices of self-government, while also considering U.S. interests and each applicant's distinct characteristics. Following the Revolutionary War, the Congress conceived a framework to guide the first U.S. territory[1] from an embryonic institution through self-governing stages until its final status was achieved. The process has grown in complexity over the years and has been applied flexibly. Since the 13 original states were formed, 37 additional states have been admitted to the Union, and one territory has opted for independence.

Although not necessarily establishing promissory or restrictive precedents, experiences of past territories can provide insight into issues likely to be deliberated by Puerto Rico and the Congress. Like Puerto Rico's debate, past status discussions centered on quests for greater political rights and equality and involved various other considerations.

After the initiative came from the territory, the Congress typically deliberated certain fundamental areas, such as the applicant's progress in self-government; social and economic development; population size and composition; geography; government organization, functions, and finances; and any unique circumstances. During such deliberations, the specific terms of the new status were worked out between the territory and the Congress. In some cases residents also were required to approve provisions of the status change legislation before the new relationship could become effective. When evaluating statehood applications, the Congress has used its broad authority and has been guided by three admission principles. The Senate committee report accompanying the most recent admission act sets forth these standards as follows:

> (1) That the inhabitants of the proposed new state are imbued with and sympathetic toward the principles of democracy as exemplified in the American form of government;
>
> (2) That a majority of the electorate desire statehood; and
>
> (3) That the proposed new state has sufficient population and resources to support a state government and to provide its share of the cost of the Federal government.

The Congress has been guided by tradition, but it also has been adaptable and used discretion in applying these principles. In assessing political and financial information during statehood deliberations, the Congress has usually required or prohibited certain practices as admission conditions and provided land grants and other transitional assistance to foster economic development and support public services.

Although statehood deliberations have resulted in some trends, the Congress' broad authority—combined with each state's unique characteristics and the increased complexity of government responsibilities—has led to many variations in admission procedures, time elapsed before attaining statehood, prerequisite conditions, and assistance provided.

Many elements considered during statehood deliberations also were analyzed when the Congress accepted the only decision by a U.S. territory to become independent. Throughout the Philippines' efforts to gain autonomy, the Congress closely monitored the territory's progress in self-government and social, fiscal, and economic development. Also, the Congress required that certain conditions be met and enacted special trade preferences and other measures to assist the Philippines' transition to independence.

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[1] For this section, a territory is defined as a part of the United States that is not a state. The District of Columbia is not included in this definition.

The various procedures and terms established in admitting states and granting independence were analyzed in detail in our 1980 report, Experiences of Past Territories Can Assist Puerto Rico Status Deliberations (GGD-80-26).

Varying Legal Concepts of Commonwealth

Although the creation of the Commonwealth in 1952 was recognized as a further step toward self-government for Puerto Rico, different interpretations regarding the island's relationship with the Federal Government have arisen. Prior to the establishment of the Commonwealth, Puerto Rico was considered an unincorporated territory. Since then, the question of whether Puerto Rico's status has changed has been the subject of much analysis and debate. Some believe that the commonwealth is a new entity and no longer a territory within the meaning of the territorial clause of the U.S. Constitution. While some consider the commonwealth another type of unincorporated territory short of statehood, still others contend that it did not change Puerto Rico's political and legal status.

Congressional committee reports disclosed that the commonwealth status provided more self-government but would not "preclude a future determination by the Congress of Puerto Rico's ultimate political status [and] ". . . would not change Puerto Rico's fundamental political, social, and economic relationship to the United States." However, the precise legal definition of commonwealth has not been determined. The 1966 report by the Commission on the Status of Puerto Rico noted that this unclear legal relationship is not a unique situation.

> In short, a Federal relationship—whether it be commonwealth or statehood—is never completely clear. Rather, there is a necessary and desirable obscure fringe area which permits many legal, political, and practical adjustments to take place. It is true that Commonwealth has many areas of uncertainty because it is novel. But it is also true that commonwealth like statehood has many areas of uncertainty because of the nature of a Federal relationship.

The U.S. Supreme Court has not directly considered Puerto Rico's status since 1922. The issue has been discussed in lower federal courts and the Puerto Rico Supreme Court, but these rulings did not clarify the broad status issue. Further discussion of U.S. court cases related to Puerto Rico's status is contained in section 4.

When Puerto Rico became a commonwealth in 1952, it was removed from the Interior Department's jurisdiction and assumed responsibility for its own internal affairs. No single Federal agency was directed to replace Interior, and Puerto Rico has continued its singularly unique relationship to the Federal government since that time. In 1961, a presidential memorandum directed that matters pertaining to Puerto Rico were to be referred to "The Office of the President."

[This section is new and was not contained in the 1981 GAO report.]

SECTION 3.—FEDERAL LEGISLATION APPLYING TO PUERTO RICO

The civil government of Puerto Rico was established under the Organic Act of 1900 (the Foraker Act).[1] In 1917, a new Organic Act was passed (the Jones Act) granting Puerto Rico greater self-government and citizenship.[2] In 1950, legislation was enacted that authorized Puerto Rico to adopt a constitution.[3] The constitution became effective in 1952. The 1950 legislation also modified the 1917 Organic Act to conform it to Puerto Rico's new relationship with the United States and renamed the Organic Act as the Puerto Rican Federal Relations Act.

Other Federal legislation enacted since the Organic Act also affects Puerto Rico in many ways. In fact, a search of a database of Federal laws mentioning Puerto Rico showed more than 1,019 references.

To narrow our review of Federal laws applying to Puerto Rico, we worked with the staff of the Senate Committee on Energy and Natural Resources and others to identify those laws which were seen as the most significant. We conducted our review in seven major areas: income support, health care, taxes, immigration, labor, environment, and trade. In these areas, we identified about 30 major laws. We have briefly summarized these statutes and described how they applied to Puerto Rico. We have not assessed their economic impact or the background behind their enactment. This is done selectively in our March 1981 report, which examines various self-determination issues.

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[1] 31 Stat. 77.

[2] Pub. L. No. 64-368, 39 Stat. 951.

[3] Pub. L. No. 81-600, 64 Stat. 319, currently found at 48 U.S.C. § 731 *et seq.*

With some exceptions, Federal laws in the seven areas we examined apply to Puerto Rico in the same manner as they do to the states. The major exceptions are income support and health care programs and income taxes. Three of the six income support programs we examined are more limited for Puerto Rico, either in funding or eligibility, than they are for the states. Funding for health care under Medicaid is capped for Puerto Rico. For Medicare, the prospective payment rates for inpatient hospital services are based on the cost of Puerto Rican hospitals rather than the national average cost as it is in the states. With regard to both individual and corporate income taxes, Federal laws generally do not apply and the operations of U.S. corporations located in Puerto Rico are likewise exempt.

Table 3.1 summarizes these laws and shows Puerto Rico is not always treated as a state under Federal law.

TABLE 3.1—COMPARISON OF THE APPLICABILITY OF SELECTED FEDERAL LAWS IN PUERTO RICO AND THE 50 STATES

Law or program	Federal law applies in the same way to Puerto Rico and the states
Income support programs:	
Adult Assistance Program	No
Aid to Families with Dependent Children	No
Child Nutrition Act	Yes
Nutrition Assistance (Food Stamps)	No
Old Age Survivors and Disability Program (Social Security)	Yes
Unemployment Insurance	Yes
Health care programs:	
Medicare	No
Medicaid	No
Tax laws	No
Immigration	Yes
Labor laws:	
Fair Labor Standards Act	Yes
Minimum Wage Act	No
National Labor Relations Act	Yes
Job Training Partnership Act	Yes
Occupational Safety and Health Act	Yes
Employee Retirement Income Security Act	Yes
Migrant and Seasonal Agricultural Worker Protection Act	Yes
Environmental laws:	
Water Resources Development Act of 1986	Yes
Abandoned Shipwreck Act of 1987	Yes
Super fund legislation	Yes
Clean Water Act	Yes
Clean Air Act	Yes
Solid Waste Disposal Act	Yes
Toxic Substances Act	Yes
Safety of Public Water Systems Act	Yes
Noise Control Act	Yes
Navigation and Navigable Waters Act	Yes
Emergency Planning and Community Right-to-Know Act	Yes
Trade laws:	
Tariff Act of 1930	Yes
Trade Act of 1974	Yes
Agricultural Adjustment Act	Yes
Export Administration Act	Yes
Caribbean Basin Economic Recovery Act	No

INCOME SUPPORT PROGRAMS

Puerto Rico participates in some Federal income support programs, or programs that have similar objectives, but is generally not treated as a state. The Federal funding for these programs is capped so that (1) Puerto Rican Residents might receive lower levels of assistance than individuals residing in a state or (2) the Commonwealth must bear a higher share of the costs. Some programs are unique to Puerto Rico, and Puerto Rico has set different eligibility requirements and provides a different set of benefits than do many of the states in other programs.

Adult Assistance Program

Puerto Rico does not participate in the Supplemental Security Income (SSI) program, which is open-ended and totally federally funded and administered. Instead, it continues the Adult Assistance program, which was superseded by SSI. The Adult Assistance program (42 U.S.C. § 1381, note) provides cash assistance to needy, aged, blind, or disabled individuals. The program is jointly funded by the Federal and Puerto Rican governments and is administered by Puerto Rico. The Federal government pays 75 percent of the costs of Puerto Rico's Adult Assistance benefit and training programs, and 50 percent of other administrative costs. Total expenditures for Adult Assistance, Aid to Families with Dependent Children (AFDC) and foster care (title IV-E assistance) is capped at $82 million for fiscal year 1989 and thereafter. In 1989, $11.9 million will be used for adult assistance programs. The average monthly adult assistance payment is $32 and the U.S. average under SSI is $362 a month.

The Commonwealth establishes eligibility criteria and benefit levels within the limits of Federal law and in accordance with a plan approved by the Department of Health and Human Services (HHS) Federal law requires that Adult Assistance recipients meet eligibility criteria similar to those for SSI—they must be 65 years old, blind, or disabled. The Federal Government requires the Commonwealth to consider, with some exceptions, all income and resources in determining eligibility. The income standards have different exceptions for the aged, disabled, and blind.

—For the aged and disabled: Of the first $80 a month of earned income, the first $20 plus one-half of the remainder is disregarded.

—For the blind: (a) The first $85 a month of earned income plus one-half of that in excess of $85, and (b) for a minimum of 12 but no more than 36 months, other income other income and resources needed to fulfill an approved plan for self-support is disregarded.

Through Federal regulations, HHS sets forth basic resource standards for potential participants. The value of a home, automobile, personal effects, and income-producing property of a potential participant (up to certain limits) may be excluded when determining compliance with resource limitations. Excluding these items, assets can not exceed $2,000 per individual in order to qualify for benefits.

Aid to Families with Dependent Children

The AFDC program does not treat Puerto Rico as a state. AFDC provides cash payments for needy children (and their caretaker relatives) through state-operated programs that are in accordance with a plan approved by HHS. The Federal Government shares part of total, program costs through a formula grant to the states, Puerto Rico, and other jurisdictions. Federal AFDC funding to states is open-ended, while Federal funding is capped for Puerto Rico at $82 million for fiscal year 1989. The states and Puerto Rico can choose between two Federal cost-sharing arrangements. They can use either a prescribed formula or the federal matching rates used for Medicaid. Currently, all states and Puerto Rico use the Medicaid rate, which ranges from 50 to 83 percent depending on per capita income. However, for AFDC, Puerto Rico's Medicaid rate is fixed at 75 percent by Federal law, up to the funding cap. The reimbursement rate for the states' and Puerto Rico's administrative costs is 50 percent except for planning, design development, and installation of certain mechanized claims processing and information retrieval systems, which are shared at 90 percent. AFDC is authorized as title IV-A of the Social Security Act, as amended (42 U.S.C. § 601 *et seq.*). It was recently amended by the Family Support Act of 1988 (42 U.S.C. § 1305 note).

Puerto Rico, like the states, defines need, establishes income and resource requirements, and sets benefit levels within Federal limits. Federal regulations require each State and Puerto Rico to establish a need standard and payment amounts. A need standard is the amount of funds needed to meet daily living requirements. A payment standard is the amount a state or Puerto Rico will pay to a family that has no other countable income. Both the need standard and payment amounts in Puerto Rico are lower than any state or territory.

AFDC assistance is provided to needy children, generally under 18, deprived of support because of their parents' continued absence from home, incapacity, death, or—at state and Puerto Rico's option—unemployment of the principal wage earners. Unlike a number of states, Puerto Rico does not provide assistance to two-parent families in which the primary wage earner is unemployed. But under the Family

Support Act (42 U.S.C. § 607 note (1988)) these states and the Commonwealth will be required to provide such assistance as of October 1, 1992, for 6 months a year. The act also allows emergency services to be funded, and coverage may be extended to "essential persons"—individuals determined essential to a recipient's wellbeing. Puerto Rico already provides emergency services.

Additionally, countable income—gross income minus disregards for earned and unearned income—must be below the applicable need standard. Federal law mandates a number of income disregards. In addition, Puerto Rico disregards certain other income of a dependent child, including up to 6 months of income from the Job Training Partnership Act.[4] Unearned income is disregarded completely.

In addition to income criteria, AFDC applicants are not allowed to have assets exceeding a specific dollar amount. For example, resources are limited to $1,000, excluding (1) a home, (2) an automobile with equity value to $1,500, and (3) burial plots and funeral agreements valued up to $1,500 per person. Generally, the gross income of any child or relative claiming AFDC, including certain income of stepparents and the income of an alien's sponsor deemed available to the applicant, must be below 185 percent of the applicable "need standards" established by the state or area in which the applicant resides.

Child Nutrition Act

The Child Nutrition Act of 1966 (42 U.S.C. § 1771 *et seq.*) treats Puerto Rico as a state. Its purpose is to safeguard the health and well-being of the nation's children and to encourage domestic consumption of agricultural and other foods. The act sets up a special program to encourage milk consumption by children, the school lunch program, and a supplemental food program for women, infants, and children.

Nutrition Assistance (Food Stamps)

Puerto Rico is excluded from participation in the Food Stamp program. It has a separate Federal Nutrition Assistance program (7 U.S.C. § 2028) which is a block grant through which cash is provided to needy households to purchase food. In addition, a small portion of the funds is used to stimulate food production and distribution. The program is administered by Puerto Rico within funding and other limits established by Federal law and under a plan reviewed and approved annually by the Department of Agriculture.

Unlike Federal funding for the Food Stamp program, which is open-ended, Federal funding for administrative and benefit costs of food assistance in Puerto Rico was capped at $825 million per year in 1981. Beginning in 1987, the Congress legislated annual increases to the authorized amount. A funding ceiling of $937 million is authorized for fiscal year 1990. One hundred percent of benefit costs are paid by the Federal Government under Puerto Rico's program Administrative costs are shared on a 50/50 basis between the Federal Government and Puerto Rico.

The method of calculating Nutrition Assistance benefits is similar to that for the Food Stamp program. The allowable disregards are deducted from gross income to determine countable income and assistance is provided using adjusted Food Stamp tables from 1982.

Puerto Rico allows a standard deduction of $40 per month plus 20 percent of earned income except in self-employment cases. A combined maximum of up to $40 per month for shelter, child care, and/or disabled care may also be deducted. In the case of households with elderly or disabled persons, shelter expenses in excess of 50 percent of monthly adjusted income may be deducted. In addition, up to $100 per month of monthly medical expenses may be deducted for households with elderly or disabled persons.

Benefits are paid in cash and vary monthly. Because the program is capped, total monthly available funds are divided by total monthly required funds to establish an adjustment factor for recipients' benefits. Monthly benefits are adjusted up or down depending on the previous month's factor.

Old Age Survivors and Disability Program (Social Security)

Puerto Ricans are treated the same as residents of states under the Old Age Survivors and Disability Program, title II of the Social security Act (42 U.S.C. § 301 *et seq.*) It is a national program of contributory social insurance in which employees, employers, and self-employed people pay taxes that are pooled in special trust funds. When earnings stop or are reduced because the worker retires, dies, or becomes disabled, monthly cash benefits are paid to partially replace the earnings the family has lost.

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[4] The Job Training Partnership Act of 1982 (Public Law 97-300) provides grants for job training and related assistance to economically disadvantaged individuals and others who face significant employment barriers.

Unemployment Insurance Program

Puerto Rico is treated as a state under the Unemployment Insurance program, title III of the Social Security Act (42 U.S.C. §§ 502, 503) The program is a joint federal-state effort to provide temporary and partial wage replacement to workers unemployed through no fault of their own. Within broad Federal guidelines, states establish their own employer tax structure, eligibility requirements, and benefit levels. State imposed employer payroll taxes fund the benefits and federally imposed employer payroll taxes fund program administration.

HEALTH CARE PROGRAMS

Puerto Rico is generally treated as a state under the Medicare program, with one exception as discussed below. Puerto Rico is not treated as a state under the Medicaid program. Funding for Medicaid is capped in Puerto Rico and this results in differences in the services Puerto Rico offers and its eligibility requirements.

Medicare

The Medicare program is generally administered in Puerto Rico in the same way it is administered in the states. Medicare (42 U.S.C. § 1395 *et seq.*) is a Federal program that pays much of the health care costs of almost all people aged 65 and over and certain disabled people. The one difference in Puerto Rico's treatment under the Medicare program is that Puerto Rico's prospective payment rate is based on the cost of hospitalization in the island. In the states these costs are based on a national average.

Medicaid

The Medicaid program is different in Puerto Rico than it is in the states. Medicaid (42 U.S.C. § 1396 *et seq.*) provides funding for medical assistance to low-income persons who are aged, blind, disabled, or members of families with dependent children. The federal government shares part of total program costs through a formula grant available to the states and other jurisdictions, including Puerto Rico. The program is essentially designed and administered by the states and Puerto Rico within Federal limits and in accordance with plans approved by HHS.

Federal funding for the Medicaid program in the states is open-ended; in Puerto Rico it is capped. A funding ceiling of $79 million is authorized for fiscal year 1990. The Federal financing participation rates for states' Medicaid benefits (except for family planning which is reimbursed at 90 percent) is based on a formula that takes into account states' per capita income, with limits that may be no lower than 50 percent and no higher than 83 percent. The rate for Puerto Rico is fixed at 50 percent by Federal law, up to the funding cap. The sharing rates for administrative expenses are 75 percent for training, conducting utilization reviews, operating mechanized claims processing, information retrieval, fraud control, and hospital costs-determination systems; 90 percent for establishing the mechanized claims processing and fraud control systems; and 50 percent for the remaining administrative costs.

The states and Puerto Rico must serve the "categorically needy," which includes (1) recipients of cash assistance through programs such as AFDC and SSI (Adult Assistance in the case of Puerto Rico.) In addition, states and Puerto Rico may opt to serve "medically needy" individuals—those who do not qualify as categorically needy but who cannot afford necessary health care. Puerto Rico has opted to serve:

—persons eligible for but not receiving Adult Assistance or AFDC;

—persons in a medical facility who, if they left the facility, would be eligible for cash assistance;

—the spouse of an Adult Assistance recipient who is living with the recipient and who has been determined to be essential to the recipient's well-being;

—all individuals under age 21 who would be eligible for AFDC except that they do not qualify as dependent children; and

—individuals who would be eligible for Adult Assistance or AFDC if Puerto Rico's coverage were as broad as allowed under the Federal law, including families with unemployed parents.

Puerto Rico also extends coverage to (1) pregnant women, (2) medically needy individuals under 21, (3) caretaker relatives, (4) the aged, (5) the blind, (6) the disabled, and (7) eligible spouses of aged, blind, or disabled individuals.

Income eligibility limits for the "medically needy" differ between states and Puerto Rico (42 C.F.R. 436.811-436.814). For states, the medically needy are limited by regulation to those with income no greater than 133 1/3 percent of the AFDC payment standard for a family of the same size. For Puerto Rico, Federal regulations set minimum income limits; the Health Care Financing Administration must approve limits greater than this minimum. For fiscal years 1985-89, Puerto Rico's approved income limit per month for a family of two was $400, while 133 1/3 percent of its AFDC payment standard was $74. Thus some Medicaid participants in Puerto Rico would not be eligible if the more stringent eligibility limits used in the states were applied.

TAX LAWS

Puerto Rico is not subject to Federal individual or corporate income tax laws. Since 1919, with the passage of the Revenue Act of 1918,[5] Puerto Rico has adopted its own tax law. In this respect, Puerto Rico is similar to a foreign country having a separate taxing authority.

Two provisions in Federal tax law are designed to encourage industry and improve the Puerto Rican economy. A Federal tax credit for corporations earning income in Puerto Rico has been in effect since the enactment of the Revenue Act of 1921,[6] although the nature of the tax benefit has undergone many changes. One of the most significant tax provisions affecting Puerto Rico is section 936 of the Internal Revenue Code (26 U.S.C. § 936).[7] It is designed to encourage U.S. businesses to invest in Puerto Rico and U.S. possessions. The section 936 tax credit has the effect of exempting the income U.S. firms earn from business operations and certain financial investments in Puerto Rico from the Federal corporate income tax. The tax credit is equal to the amount of U.S. tax imposed upon that share of its income a corporation derives from its business in Puerto Rico.

Another important tax provision is section 7652(a) of the Internal Revenue Code (26 U.S.C. § 7652(a)) governing shipments to the United States. Taxes collected under the internal revenue laws on items produced in Puerto Rico and sold on the U.S. mainland or consumed on the island are to be paid into the Treasury of Puerto Rico. The rate of tax under this provision is the same as that imposed on the 50 states for articles of like nature. There are some limits to this provision. Manufactured items, although actually imported from Puerto Rico, are not treated as Puerto Rican products unless the sum of the cost or value of the materials produced in Puerto Rico, plus the direct cost of processing operations performed in Puerto Rico, equals or exceeds 50 percent of the value of the item at the time it is brought into the United States. Similarly, distilled products are not treated as if they were produced in Puerto Rico unless 92 percent of their alcoholic content is attributable to rum.

IMMIGRATION

In 1917, Puerto Ricans were granted U.S. citizenship (8 U.S.C. § 1402). Immigration into Puerto Rico is subject to the same provisions as in the states.

LABOR LAWS

Under the seven acts we examined, Puerto Rico is treated the same as a state with the exception of the Minimum Wage Act.

Fair Labor Standards Act

Puerto Rico is treated as a state under the Fair Labor Standards Act (29 U.S.C. § 201 *et seq.*). The act provides Federal standards concerning minimum wage, overtime pay, child labor, and employer record keeping, among other standards, in order to prevent labor conditions in the United States detrimental to the maintenance of a minimum standard of living necessary for the health, efficiency, and general well-being of workers.

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[5] Pub. L. No. 65-254, 40 Stat. 1057.

[6] Pub. L. No. 67-98, 42 Stat. 227.

[7] See GAO reports Puerto Rico's Political Future: A Divisive Issue—With Man Dimensions, (GAO/GGD-81-48, March 2, 1981), pp. 69-77, and Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam and American Samoa, (GAO/HRD-87-60, September 15, 1987) pp. 124-137, for a more detailed discussion of the background of this provision and its significance.

Minimum Wage Act

Under the Minimum Wage Act (29 U.S.C. § 206) which is part of the Fair Labor Standards Act, special industry committees in Puerto Rico were empowered to gradually increase minimum wages until they reached the Federal minimum wage level. When that level was reached, the industry committees became inactive. Currently, Puerto Rico has the same $3.35 an hour minimum wage as the states.

National Labor Relations Act

The National Labor Relations Act, as amended by the Labor Management Relations Act (29 U.S.C. § 151 *et seq.*) treats Puerto Rico as a state. It prescribes certain rights for management and labor with respect to each other and establishes a framework for settling labor-management disputes. The act establishes the National Labor Relations Board (NLRB) which has a regional office in Puerto Rico, to carry out its provisions. Although the law itself is silent on the question of how and if it applies to Puerto Rico, case law has established that it does apply. (*See NLRB* v. *Security National Life Insurance Company*, 494 F. 2d 336 (1st Cir. 1974)).

Job Training Partnership Act

The Job Training Partnership Act (29 U.S. C. § 1501 *et seq.*) treats Puerto Rico as a state. The purpose of the act is to establish programs to prepare youth and unskilled adults for entry into the labor force and to afford job training to those economically disadvantaged individuals and other individuals facing serious barriers to employment, who are in special need of such training to obtain productive employment.

Occupational Safety and Health Act

The Occupational Safety and Health Act (29 U.S.C. § 652 *et seq.*) treats Puerto Rico as a state. It is designed to ensure safe and healthful working conditions in the United States. The act authorizes the Secretary of Labor to set mandatory occupational safety and health standards and enforce compliance with those standards. The act also encourages the states to operate, with the Secretary's approval, their own safety and health programs. The Secretary has authorized Puerto Rico to operate such programs.

Employee Retirement Income Security Act

The Employee Retirement Income Security Act (29 U.S.C. § 1001 *et seq.*) treats Puerto Rico as a state. It authorizes the Secretary of Labor to monitor and regulate employees' pension benefit programs by requiring disclosure; setting standards for pension plan administrators; and providing remedies, sanctions, and ready access to Federal courts for participants. The act also requires plans to vest the accrued benefits of employees with significant periods of service, sets minimum plan funding standards, and requires termination insurance.

Migrant and Seasonal Agricultural Worker Protection Act

The Migrant and Seasonal Agricultural Worker Protection Act (29 U.S.C. § 1801 *et seq.*) treats Puerto Rico as a state. The act authorizes the Secretary of Labor to require farm labor contractors to register and to comply with disclosure requirements to stop activities detrimental to migrant and seasonal workers.

ENVIRONMENTAL LAWS

Generally, Federal environmental legislation treats Puerto Rico as a state. However, certain laws also target Puerto Rico for special projects.

Water Resources Development Act

The Water Resources Development Act of 1986 (33 U.S.C. § 2201 *et seq.*) allots funds for the study and improvement of public waterways. Several projects under this act were intended to improve Puerto Rico's waterways. Specifically, it includes projects to improve the navigation in San Juan Harbor, Fajardo Harbor, and Guayanes Harbor; a project to improve flood control in Rio Puerto Nuevo and a flood control feasibility study in Guayanilla River basin; and the removal of the abandoned vessel "A. Regina" from the waters off Mona Island.

Abandoned Shipwreck Act

The Abandoned Shipwreck Act of 1987 (43 U.S.C. § 2101 *et seq.*) gives the states (including Puerto Rico) title to any abandoned vessels embedded in state-owned submerged lands. Puerto Rico gained title to submerged lands around the island, extending out 3 Spanish leagues (10.9 miles) as part of the Organic Act of 1917. (See 48 U.S.C. § 749).

Superfund Legislation

The Comprehensive Environmental Response, Compensation, and Liability Act of 1980, commonly referred to as the Superfund legislation (42 U.S.C. § 9601 *et seq.*) treats Puerto Rico as a state. The act sets guidelines for reporting and responding to the release of hazardous pollutants into the environment.

Clean Water Act

Puerto Rico is treated as a state under the Water Pollution Prevention and Control Act (33 U.S.C. § 1251 *et seq.*) commonly known as the Clean Water Act. The objective of the act is to restore and maintain the chemical, physical, and biological integrity of the nation's waters. Federal agencies are directed to cooperate with state and local agencies to develop comprehensive solutions to prevent, reduce, and eliminate pollution in concert with programs to manage water resources.

Clean Air Act

Puerto Rico is treated as a state under the Air Pollution Prevention and Control Act (42 U.S.C. § 87401 *et seq.*) known as the Clean Air Act. The purpose of the act is to protect and enhance the quality of the nation's air resources so as to promote the public health and welfare and the productive capacity of its population. This is accomplished by providing for the establishment of minimum air quality standards, initiating national research and development to prevent and control air pollution, and by providing technical and financial assistance to states to facilitate air pollution prevention and control programs.

Solid Waste Disposal Act

The Solid Waste Disposal Act (42 U.S.C. § 6901 *et seq.*) treats Puerto Rico as a state. The act is designed primarily to aid state and local governments through technical and financial assistance in reprocessing or disposing of used oil, garbage, sludge, etc. This is accomplished through training grants involving the design, operation, and maintenance of solid waste disposal systems; by setting guidelines and regulating treatment, storage, and disposal of hazardous wastes; and by prohibiting future open dumping of solid waste on land.

Toxic Substances Act

The Toxic Substances Act (15 U.S.C. § 2601 *et seq.*) treats Puerto Rico as a state. The act authorizes the Administrator of the Environmental Protection Agency (EPA) to require the testing of certain potentially environmentally hazardous substances or mixtures in order to develop data on health and environment effects.

Safety of Public Water Systems Act

The Safety of Public Water Systems Act (42 U.S.C. § 300f *et seq.*) treats Puerto Rico as a state. It authorizes the EPA Administrator to issue drinking water regulations that specify the maximum allowable contaminant levels in water.

Noise Control Act

The Noise Control Act (42 U.S.C. § 4901 *et seq.*) treats Puerto Rico as a state. The act requires the EPA Administrator to issue federal noise emission standards to help promote an environment free from noise that jeopardizes people's health and welfare.

Navigation and Navigable Waters Act

The Navigation and Navigable Waters Act (33 U.S.C. § 1401 *et seq.*) treats Puerto Rico as a state. It authorizes the EPA Administrator to regulate the dumping of all types of materials into ocean waters and to prevent or strictly limit the dumping into ocean waters of any material that would adversely affect human health, the marine environment, ecological systems, or economic opportunities.

Emergency Planning and Community Right-to-Know Act

The Emergency Planning and Community Right-to-Know Act (42 U.S.C. § 11001 *et seq.*) treats Puerto Rico as a state. The act authorizes the EPA Administrator to prescribe regulations to enforce the reporting and disclosure requirements for substances that he or she has classified or defined in the Code of Federal Regulations as extremely hazardous substances or as hazardous chemicals. It also includes toxic chemicals listed in Committee Print 99-169 of the Senate Committee on Environment and Public Works. The act directs the governor of each state to appoint a State Emergency Response Commission that will develop an emergency plan for the state.

TRADE LAWS

Puerto Rico is treated as a state in each of the five pieces of legislation we examined. The various trade acts are administered by different agencies throughout the government. For example, the Departments of the Treasury (Customs) Commerce, and Agriculture all administer various aspects of Federal trade laws. In addition to trade legislation are numerous trade agreements between the United States and other countries regarding a broad spectrum of American manufacturing and produce. These agreements are often item-specific (for example an agreement regarding the export of steel or textiles to the United States). These trade agreements were beyond the scope of our review.

Tariff Act of 1930

The Tariff Act of 1930, as amended (19 U.S.C. § 1202 *et seq.*) treats Puerto Rico as a state. This act has been amended to include several important trade provisions designed to protect American industry by regulating imports and exports, and prohibiting "unfair methods of competition and unfair acts in the importation of articles into the United States. . . ." (19 U.S.C. § 1337b).

The General Tariff Schedule (19 U.S.C. § 1202) is one of the primary sections of the Tariff Act of 1930. Puerto Rico is within the general customs territory of the United States. This means that Puerto Rico is treated the same as a state under Customs authority.

Antidumping (19 U.S.C. § 1673) and countervailing duties provisions (19 U.S.C. § 1671) are two other sections of the Tariff Act of 1930. In both provisions, Puerto Rico is treated as a state. Duties are imposed on imports into the United States to correct unfair practices that benefit imports over domestically produced goods. Antidumping duties are placed on imports that are sold in the United States at a price lower than in the country where they are produced (dumping). Countervailing duties are levied to counteract export or other subsidies provided by the producing country for goods that are imported into the United States. Generally, antidumping or countervailing duties are applied only if an import materially injures or threatens to materially injure a U.S. industry or materially retards the establishment of an industry in the United States.

Two other provisions of the Tariff Act of 1930 treat Puerto Rico different than a state. These provisions authorize Puerto Rico's legislature to impose a duty on coffee imported into Puerto Rico (19 U.S.C. §§ 1319, 1319a).

Trade Act of 1974

The Trade Act of 1974 (19 U.S.C. § 2101 *et seq.*) treats Puerto Rico as a state. It sets out goals and standards for trade agreements between the United States and foreign countries. The act also attempts to eliminate trade barriers and protect American industry from unfair and injurious import competition.

Agricultural Adjustment Act

The Agricultural Adjustment Act, as amended, (7 U.S.C. § 601 *et seq.*) treats Puerto Rico as a state. The act authorizes the President to impose fees or quotas on imported products that undermine any Department of Agriculture domestic commodity program. The act is designed to prevent imports from interfering with Agriculture's efforts to stabilize or raise domestic agricultural commodity prices.

Export Administration Act

The Export Administration Act (50 App. U.S.C. § 2401 *et seq.*) includes Puerto Rico in its definition of the United States. The act regulates the export of goods and technology that would prove detrimental to the security of the United States. The act grants the President authority to limit or suspend exports of U.S. commodities and technical data to foreign destinations for any of three specified purposes: to protect the national security, to ensure against an excessive drain of scarce goods, and to further foreign policy objectives.

Caribbean Basin Economic Recovery Act

The Caribbean Basin Economic Recovery Act (19 U.S.C. § 2701 *et seq.*) commonly known as the Caribbean Basin Initiative, has special provisions applying to Puerto Rico. It authorizes certain U.S. unilateral and preferential trade and tax measures for Caribbean Basin countries and territories. The act benefits Puerto Rico by allowing duty-free treatment of products, a percentage of which was produced or processed in Puerto Rico but sold by one of the Caribbean beneficiary nations. For the purpose of determining whether the foreign product referred to above qualifies for duty-free treatment, the Commonwealth of Puerto Rico is defined as a "beneficiary country."

[This section has been reprinted from the 1981 GAO report. It has not been updated.]

SECTION 4.—SYNOPSIS OF THE HISTORY OF PUERTO RICO'S STATUS IN UNITED STATES COURTS

Prior to attaining Commonwealth status in 1952, Puerto Rico was considered an unincorporated territory of the United States. Since that time there has been much debate, study, and speculation on whether Puerto Rico's status has changed. Although the United States Supreme Court has not directly considered the status of the Commonwealth of Puerto Rico, the issue has been discussed in several lower Federal courts. The precise legal definition of the term "Commonwealth," however, has not been determined.

PRE-COMMONWEALTH LEGAL STATUS DEPENDENT ON INSULAR CASES

In the early 20th century, the United States Supreme Court addressed the status of territories in a group of decisions known as the Insular Cases. These decisions considered primarily the status of Puerto Rico and the Philippines acquired by the United States from Spain in the 1898 Treaty of Paris.

In a 1901 case,[1] the court was faced with the immediate issue of whether merchandise brought into New York from Puerto Rico was subject to the payment of duties, as prescribed by Puerto Rico's First Organic Act.[2] An answer to that question involved a determination of whether the duties were levied in such a way as to be repugnant to Art. I, § 8, cl. 1 of the United States Constitution.[3] That determination depended on whether Puerto Rico was considered an incorporated or unincorporated territory.

The difference between incorporated and unincorporated status, in part, lay in the extent of applicability of the United States Constitution. If a territory were unincorporated, authority of the Congress over it was plenary,[4] that is, limited only by the "fundamental parts" of the Constitution.[5] However, if incorporated, then the entire Constitution would be applicable, and the Congress would thereby be limited by all the provisions of the Constitution in exercising its authority. Although several cases already had held that territorial inhabitants enjoyed the protection of personal and civil rights implicit in principles of constitutional liberty, those decisions made no distinction between incorporated and unincorporated territories.[6]

In assessing whether Puerto Rico had been incorporated, Justice White compared the provisions in other territorial acts and that of Puerto Rico and found that:

> There has not been a single cession made from the time of the Confederation up to the present day, excluding the recent treaty with Spain, which has not contained stipulations to the effect that the United States through Congress would either not disincorporate or would incorporate the ceded territory into the United States.[7]

Although the Treaty of Paris contained no such provisions, it stated:

> Spain cedes to the United States the Island of Porto Rico and other islands now under Spanish sovereignty in the West Indies, and the Island of Guam in the Marinas or Ladrones . . . . The civil rights and political *status* of the native inhabitants of the territories hereby ceded to the United States shall be determined by the Congress.[8]

On the basis of the quoted treaty provision, Justice White concluded that the express purpose of the treaty was not only to leave the status of Puerto Rico to be determined subsequently by the Congress, but to prevent the treaty from operating to the contrary.[9] Accordingly, he found that since the Congress did not expressly incorporate Puerto Rico, it could establish a government not subject to all the restrictions of the Constitution. Thus, because the Congress was not bound by the uniformity clause, it could impose duties on goods coming into the United States from Puerto Rico.[10]

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[1] *Downes* v. *Bidwell*, 182 U.S. 244, 287 (1901).

[2] 31 Stat. 77, April 12, 1900 (Foraker Act).

[3] That clause states that "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the Common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."

[4] The Congress' authority is exercised both as an incident to its right to acquire territory and on the territorial clause of the Constitution, Art. IV, § 3, cl. 2. Dorr v. United States, 195 U.S. 138, 146 (1904). The territorial clause states: "The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States . . . ."

[5] 182 U.S. at 290-291, 341-344.

[6] *Murphy* v. *Ramsey*, 114 U.S. 15, 44-45 (1885); *Church of Jesus Christ of Latter Day Saints v. United States*, 136 U.S. 1, 44 (1890).

[7] 182 U.S. at 318-19.

[8] Id. at 339-40.

[9] Id. at 340.

Several years after *Downes* the Court considered questions involving the status and applicability of the United States Constitution to Hawaii, the Philippines, and Alaska.[11]

In *Hawaii* v. *Mankichi*, Justice White considered whether Hawaii had been incorporated by the Newlands Resolution of 1898,[12] prior to its being specifically incorporated into the Union by its First Organic Act in 1900.[13] In finding that the islands were not incorporated by the Newlands Rolution, Justice White, in part, pointed to the following:

> By the resolution the islands were annexed, not absolutely, but merely "as a part of the territory of the United States," and were simply declared to be subject to its sovereignty. The minutest examination of the resolution fails to disclose any provision declaring that the islands are incorporated and made a part of the United States or endowing them with the rights which would arise from such relation. On the contrary, the resolution repels the conclusion of incorporation. Thus it provided for the government of the islands by a commission, to be appointed by the President until Congress should have opportunity to create the government which would be deemed best.[14]

On the other hand, in *Rassmussen* v. *United States*, the court found Alaska to be incorporated in view of:

> (1) Article 3 of the treaty with Russia which provided that the people of Alaska should enjoy all the rights, advantages and immunities of citizens of the United States; and should be maintained and protected in the free enjoyment of their liberty, property, and religion.
>
> (2) The actions of Congress concerning internal-revenue taxation and extension of United States Laws relating to customs, commerce and navigation over Alaska and establishing a collection district in Alaska.
>
> (3) The recognition of the incorporated status of Alaska in prior decisions of the Supreme Court.[15]

The status of Puerto Rico was again considered by the Supreme Court in *Balzac* v. *Puerto Rico*,[16] several years after the enactment of the Organic Act of 1917,[17] (The Jones Act). That act established a revised civil government for Puerto Rico; provided for a bill of rights including substantially all the guaranties of the United States Constitution other than those relating to indictment by grand jury and right of jury trial in criminal and civil cases; and with minor exceptions provided United States citizenship to Puerto Ricans. The issue presented to the court was whether a defendant was entitled to a jury trial for a misdemeanor, the Puerto Rican Code providing only for jury trials in felony cases.[18]

Although the court acknowledged that citizenship was an important factor in determining whether a territory was incorporated, it held that the Organic Act of 1917 did not incorporate Puerto Rico into the Union. Moreover, it noted that:

> Incorporation has always been a step, and an important one, leading to statehood. Without, in the slightest degree, intimating an opinion as to the wisdom of such a policy, for that is not our province, it is reasonable to assume that when such a step is taken it will be begun and taken by Congress deliberately and with a clear declaration of purpose, and not left a matter of mere inference or construction.[19]

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[10] 182 U.S. at 340-42.

[11] *Hawaii* v. *Mankichi*, 190 U.S. 197 (1903); *Dorr* v. *United States*, 195 U.S. 138 (1904); *Rassmussen* v. *United States*, 197 U.S. 516 (1905). In those cases, the Court found Hawaii and the Philippines to be unincorporated but Alaska to be incorporated.

[12] 30 Stat. 750.

[13] 31 Stat. 141.

[14] 190 U.S. at 219.

[15] 197 U.S. at 520-25.

[16] 258 U.S. 298 (1922).

[17] 39 Stat. 951.

[18] 258 U.S. at 302.

[19] Id. at 311.

COMMONWEALTH STATUS

Prior to 1952 there was little question that Puerto Rico was an unincorporated territory. Since the establishment of the Commonwealth, however, the status question has been the subject of fervid public debate and ambiguous and conflicting statements by courts.

Some believe that the Commonwealth is an entirely new entity and that Puerto Rico is no longer a territory within the meaning of the territorial clause of the United States Constitution.[20] Others consider the Commonwealth another type of unincorporated territory, the word "territory" limited to the "constitutional word for an area which is part of the United States and which is not a state." [21] Still others contend that Puerto Rico's status was changed little by forming the Commonwealth.[22]

The United States Supreme Court has not directly considered the status of the Commonwealth. In *Examining Board* v. *Flores de Otero,*[23] however, the court stated that: "Puerto Rico occupies a relationship to the United States that has no parallel in our history." On the other hand, recently the court, *per curiam*, found that the Congress was empowered under the territorial clause of the Constitution to treat Puerto Rico differently from the states so long as there was a rational basis for doing so, and it held that Puerto Rico could receive less assistance than the states under the Aid to Dependent Children program.[24] Although it could be argued that this holding suggests that the court still views Puerto Rico as an unincorporated territory of the United States, since the status issue was not directly considered, it is uncertain that the rationale of the case would extend beyond its particular facts.

In some instances, Federal appellate courts have suggested that the compact creating the Commonwealth did nothing to change Puerto Rico's status. In one case, the United States Court of Appeals for the Seventh Circuit stated:

> The legislative history of the Act providing for this last change in the government of Puerto Rico shows very definitely that those members of Congress most responsible for its enactment thought that the Act would not change Puerto Rico to some political entity other than a territory. The Senate Report explaining and recommending the passage of this bill, U.S. Code Congressional and Administrative Service, 1950, Volume 2, page 2682 stated:
>
> > It is important that the nature and general scope of 53336 be made absolutely clear. The bill under consideration would not change Puerto Rico's *fundamental political*, social, and economic relationship to the United States.
>
> Again, on page 2683 of the same volume, the report stated:
>
> > This bill does not commit the Congress . . . to the enactment of statehood legislation for Puerto Rico in the future. Nor will it in any way preclude a future determination by the Congress of Puerto Rico's *ultimate political status.* [25]

Decisions of the United States Court of Appeals for the First Circuit also seem to indicate that Puerto Rico's status did not change in 1952.[26] However, the statements made by that court are less clear than those in *Detras, supra*. Thus, in *Guerrido* v. *Alcoa Steamship Co.*,[27] the court noted that Puerto Rico was neither a state nor a territory which had been incorporated into the Union preliminary to statehood, citing *Balzac*. Yet, in another instance Judge Magruder, a long-time student of Puerto Rican affairs, stated:

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[20] *See Cosentino* v. *International Longshoremen's Association*, 126 F. Supp. 420, 422 (D.P.R. 1954).

[21] Leibowitz, A. H., *The Applicability of Federal Law to the Commonwealth of Puerto Rico*, 56 Geo. L.J. 219, 243 (1967).

[22] *See e.g., Detres* v. *Lions Building Corp.*, 234 F. 2d 596, 599-600 (7th Cir. 1956).

[23] 426 U.S. 572, 596 (1976).

[24] 42 U.S.C. §§ 601 *et seq. Harris* v. *Rosario*, 64 L. Ed. 2d 587, 588 (1980).

[25] 234 F.2d at 599-600.

[26] Prior to 1961, decisions of the Supreme Court of Puerto Rico were appealed to the United States Court of Appeals for the First Circuit. Since 1961 appeals from the Supreme Court of Puerto Rico are treated similarly to those of a state and are heard by the United States Supreme Court. 28 U.S.C. § 1258 (1976).

[27] 234 F.2d 349, 352 (1st Cir. 1956).

> Albeit, as a general rule, the *status* of a particular territory has to be taken in view when the applicability of any provision of the Constitution is questioned, it does not follow when the Constitution has absolutely withheld from the government all power on a given subject, that such an inquiry is necessary. Undoubtedly, there are general prohibitions in the Constitution in favor of the liberty and property of the citizen which are not mere regulations as to the form and manner in which a conceded power may be exercised, but which are an absolute denial of all authority under any circumstances or conditions to do particular acts. In the nature of things, limitations of this character cannot be under any circumstances transcended, because of the complete absence of power.[32]

In another opinion Justice Brown provided additional guidance:

> Whatever may be finally decided by the American people as to the *status* of these islands and their inhabitants—whether they shall be introduced into the sisterhood of States or be permitted to form independent governments—it does not follow that, in the meantime, awaiting that decision, the people are in the matter of personal rights unprotected by the provisions of our Constitution and subject to the merely arbitrary control of Congress. Even if regarded as aliens, they are entitled under the principles of the Constitution to be protected in life, liberty and property.[33]

Following this Insular decision, other cases further defined which parts of the Constitution were or were not applicable to Puerto Rico as an unincorporated territory. A factor that might have contributed to courts rarely expounding on which rights and protections in the United States Bill of Rights applied was the enumeration of substantially the same rights, with the exception of the grand and petit jury trial provisions, in Puerto Rico's revised Organic Act of 1917.

During the pre-Commonwealth era, the Sixth Amendment right of trial by jury,[34] Fifth Amendment protection of grand jury indictment,[35] the Commerce Clause,[36] and prohibition against the imposition of duties or imposts on imports,[37] and the Uniformity Clause [38] specifically were held inapplicable to Puerto Rico. Other protections which appeared not to apply were the Seventh Amendment right to trial by jury in civil suits,[39] and the Fifth Amendment protection against double jeopardy.[40]

Also, during this period the only constitutional provisions judicially [41] found applicable to Puerto Rico were due process,[42] and the Eighteenth Amendment prohibition.[43] Other parts of the Constitution which, in all likelihood, were applicable to pre-Commonwealth Puerto Rico were the right to habeas corpus,[44] and the Fifth Amendment right to just compensation.[45]

Post-Commonwealth Period

With the formation of the Commonwealth, the privileges and immunities clause of Article IV § 2, cl. 1 of the United States Constitution continued to be applicable through the Federal Relations Act.[46] That clause provides: "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." Although some courts have urged that Puerto Ricans as American citizens should be afforded greater United States constitutional protection, the rights of

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[32] 182 U.S. at 291, 294-95.

[33] 182 U.S. at 282-83.

[34] *Balzac* v. *Puerto Rico*, 258 U.S. 298 (1922).

[35] *Puerto Rico* v. *Tapia*, 245 U.S. 639 (1918).

[36] Art. 1, § 8, cl. 3.

[37] Art. 1, § 10, cl. 2, *Buscaglia* v. *Ballester*, 162 F.2d 805, 806-07 (1st Cir. 1947) *cert. denied* 332 U.S. 816.

[38] (Art. 1, § 8, cl. 1), *Downes* v. *Bidwell*, 182 U.S. at 342.

[39] *Puerto Rico* v. *Shell Co. Ltd.*, 302 U.S. 253, 258 (1937).

[40] *Grafton* v. *United States*, 206 U.S. 333, 345, 354-55 (1907).

[41] In 1947, the privileges and immunities clause of Article IV, § 2, cl. 1 of the United States Constitution was made applicable by an amendment to the Jones Act, "as though Puerto Rico were a state of the Union." Pub. L. No. 362 § 7, Aug. 5, 1947, 61 Stat. 772-73.

[42] *Balzac* v. *Puerto Rico*, 258 U.S. 298, 312-313 (1922).

[43] Presumably, the Twenty-First Amendment (repeal of prohibition) was also applicable. *Ramos* v. *United States*, 12 F.2d 761, 762 (1st Cir. 1926).

[44] *Eisentrager* v. *Forrestal*, 174 F.2d 961, 965 (D.C. Cir. 1949) *rev'd on other grounds sub. nom. Johnson v. Eisentrager*, 339 U.S. 763 (1950).

[45] *Mitchell* v. *Harmony*, 54 U.S. (13 How.) 115, 133-34 (1852).

[46] This provision was the only section of the Jones Act Bill of Rights which was not repealed by Pub. L. No. 600, Act of July 3, 1950, *64 Stat. 319*.

American citizens guaranteed by the privileges and immunities clause are not extensive.[47]

In *Torres* v. *Puerto Rico*,[48] the United States Supreme Court held that the Fourth Amendment to the United States Constitution was applicable to Puerto Rico, though not deciding whether that amendment applied directly or through the Fourteenth Amendment. The court also set forth other constitutional provisions found in previous Supreme Court cases to be applicable to Puerto Rico. They are the First Amendment free speech clause,[49] the due process clause of either the Fifth or Fourteenth Amendment,[50] and the equal protection guarantee of either the Fifth or Fourteenth Amendment.[51]

Prior to *Torres* several Federal court decisions suggested that the Equal Protection clause was applicable to Puerto Rico.[52] *In Rodriquez Cintron* v. *Richardson*,[53] the court held that the Puerto Rican plaintiffs were entitled to benefit from the principles of equal protection read into the Fifth Amendment. This determination by the United States District Court for Puerto Rico recently found apparent support in a ruling by the United States Court of Appeals.[54]

In an instance in which the constitutionality of sections of an abortion statute were challenged, the United States District Court for Puerto Rico suggested that Puerto Rico should be treated as a state under the Fourteenth Amendment (due process and equal protection).

> None of this makes clear just which specific provisions of the United States Constitution apply in Puerto Rico. But it does follow undeniably that at least those 'fundamental' protections of the United States Constitution, which were restraints upon the power of the pre-commonwealth government, remain in effect after formation of the Commonwealth and restrict its powers.
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> * * * * * * *
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> Finding such great similarity in the practical and theoretical application of the tests used as to both states and unincorporated territories, we may assume that the notion of "fundamental rights," which has undergone such a metamorphosis in the context of interpretation of the Fourteenth Amendment, must be deemed to have had a similar expansion as to Puerto Rico. In addition, we think that we may safely assume that when a personal right has been found applicable to the states via the Fourteenth Amendment, we may then assume that such right is applicable to Puerto Rico, regardless of the theoretical means used to achieve such a result. After all, citizens of Puerto Rico, in common with citizens of states, are citizens of the United States.[55]
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> * * * * * * *

Presently, it is uncertain whether the right to a jury trial in a criminal case, guaranteed both by Article III, § 2, cl. 3 and the Sixth Amendment to the United States Constitution, is applicable to Puerto Rico. Although in 1959 the United States Court of Appeals for the First Circuit found those provisions inapplicable,[56] in 1976, the United States District Court for Puerto Rico held the Sixth Amendment applicable.[57] Moreover, recently, a Federal district court found unconstitutional provisions in American Samoan laws and regulations denying the right to jury trial.[58] The later decisions may reflect the United States Supreme Court's holding that the right to a jury trial in a criminal case is fundamental.[59]

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[47] The privileges and immunities guaranteed by the Fourth and Fourteenth Amendments are the same. 83 U.S. at 75. See *Slaughter-House Cases*, 83 U.S. (16 Wall.) 36, 79-80 (1873).

[48] 442 U.S. 465, 471 (1979).

[49] *Balzac, supra*, at 314.

[50] *Calero-Toledo* v. *Pearson Yacht Leasing Co.*, 416 U.S. 663, 668-69 n.5 (1974).

[51] *Examining Board* v. *Flores de Otero*, 426 U.S. 572, 599-601 (1976). The Court also stated in *Califano* v. *Torres*, 423 U.S. 1, 4 n. 6 (1978) it assumed without deciding that the constitutional right to travel extends to the Commonwealth. 442 U.S. at 470.

[52] *E.g.*, *Marquez* v. *Aviles*, 252 F.2d 715, 717 (1st Cir. 1958) cert denied, 356 U.S. 952.

[53] Civ. Action No. 1099-72 (D.P.R. 1975), unpublished decision.

[54] *Molina-Crespo* v. *Califano*, 583 F.2d 572, 574 (1st Cir. 1978).

[55] *Montalvo* v. *Colon*, 377 F. Supp. 1332, 1339, 1341 (D.P.R. 1974) (Per Curiam).

[56] *Fournier* v. *Gonzalez* 269 F. 2d 26, 28-29 (1st Cir 1959).

[57] *Justiniano Matos* v. *Gaspar Rodriquez*, 440 F. Supp. 673, 674 (D.P.R. 1976).

[58] *King* v. *Andrus*, 452 F. Supp. 11, 17 (D.C. D.C. 1977).

[59] *Duncan* v. *Louisiana*, 391 U.S. 145, 149 (1968).

[This portion of section 4 is new and was not contained in the 1981 GAO report.]

FEDERAL COURT CASES SINCE 1980 THAT DISCUSS THE LEGAL STATUS OF PUERTO RICO

Before attaining commonwealth status in 1952, Puerto Rico was considered an unincorporated territory of the united States. Since that time there has been much debate, study, and speculation on whether Puerto Rico's status has changed. Although the term "commonwealth" has not been precisely defined, Federal courts have discussed the nature and consequences of Puerto Rico's status.

Our 1981 report included a synopsis of the history of Puerto Rico's status in the U.S. courts in the pre-commonwealth period and the post-commonwealth period through 1979.[1] This section focuses on court cases during the 1980s that discuss the legal status of Puerto Rico. It is presented as an update of, and should be read in conjunction with, the discussion in our 1981 report.

During the 1980s, Federal courts have rendered a number of decisions on issues where the legal status of Puerto Rico was relevant to the decision. In all but one case, the Federal courts treated Puerto Rico as a state. In this case, the Supreme Court upheld a lower reimbursement rate than that for the states under the Aid to Families with Dependent Children program.

CASES TREATING PUERTO RICO AS A STATE

The U.S. Supreme Court, Court of Appeals, and District Court all had cases in the 1980s in which they treated Puerto Rico as a state.

Supreme Court Cases

The United States Supreme Court decided several cases in the 1980s in which it treated Puerto Rico as a state. In a 1982 decision,[2] the Court applied the already well-established rule that the fundamental protections of the United States Constitution extended to the citizens of Puerto Rico.[3] The Court applied this rule to the specific issue of the right to vote, and found voting rights of Puerto Rican citizens to be constitutionally protected to the same extent as those of all other United States citizens.[4] This case involved a statute that gave a political party the right to fill an interim vacancy in the Puerto Rico legislature until the next election. The statute, which was similar to those adopted by several states to deal with untimely and unexpected vacancies in the legislature, was challenged on the grounds that it violated the right of members of the other parties to vote for a replacement. The Court found that the mechanism served to "preserve the 'legislative balance'" until the next general election could be held.[5] Quoting in part from one of its earlier decisions,[6] the Court made the point that "Puerto Rico, like a state, is an autonomous political entity, 'sovereign over matters not ruled by the Constitution.' " [7]

In another 1982 case, the Court found that Puerto Rico's sovereignty was analogous to that of a state for purposes of its right to bring a lawsuit on behalf of some of its citizens.[8] The Court allowed Puerto Rico to maintain a suit on behalf of Puerto Rican migrant farm workers against Virginia apple growers for violations of Federal law protecting united States workers, including Puerto Ricans, against discriminatory employment practices. The Court applied the same test it would have applied to a state, and concluded that Puerto Rico had a sufficient interest of its own ("quasi-sovereign" interest) beyond the private interest of the aggrieved workers, to allow it to sue on their behalf. This interest consisted of protecting its residents from the harmful effects of discrimination and, alternatively, of pursuing its residents' interest in the Commonwealth's participation in the Federal statutory employment service scheme.

In a 1986 case, the Court reviewed the constitutionality of a Puerto Rico statute and treats Puerto Rico as a state in applying a rule that gives binding effect to the construction of Puerto Rico law by Puerto Rico courts.[9] The Court said:

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[1] *See* GAO report *Puerto Rico's Political Future: A Divisive Issue with Many Dimensions*, (GGD 81-48, March 2, 1981) pp. 108-118.

[2] *Rodriquez* v. *Popular Democratic Party*, 457 U.S. 1 (1982).

[3] *See Torres* v. *Puerto Rico*, 442 U.S. 465, 469-70 (1979)

[4] *See also Lopez Lopez* v. *Aran*, discussed below, in which the United States Court of Appeals for the First Circuit reiterated that Fourth Amendment rights are fundamental constitutional rights, and added that the right to travel was similarly protected.

[5] 457 G.S. at 13.

[6] *Calero-Toledo* v. *Pearson Yacht Leasing Co.*, 416 U.S. 663, 673 (1974) which in turn had quoted from a lower court decision, *Mora* v. *Mejias*, 115 F. Supp. 610 (D.P.R. 1973).

[7] 457 U.S. at 9.

[8] *Snapp & Son, Inc.* v. *Puerto Rico*, 458 U.S. 592 (1982).

[9] *Posadas De Puerto Rico Assoc.* v. *Tourism Co.*, 478 U.S. 328 (1986).

> This would certainly be the rule in a case originating in one of the 50 States. [Citations omitted.] And we believe that Puerto Rico's status as a Commonwealth dictates application of the same rule.[10]

In a 1987 case, the State of Iowa asserted that the Extradition Clause of the Constitution did not require Iowa to extradite an individual because the Clause applied only to states, and Puerto Rico was not a state.[11] The court concluded that it did not have to decide whether the Extradition Clause applied Puerto Rico because the Extradition Act, a Federal statute implementing the Clause, did apply to Puerto Rico and required Iowa to extradite the individual. The court held that the Extradition Act, which requires extradition of fugitives at the request of a "Territory," as well as a "State," applied to Puerto Rico as a commonwealth. The court reasoned that when Puerto Rico's status was changed from that of territory to that of commonwealth, the legislation that accomplished the change "did not remove from the Government of the Commonwealth any power to demand extradition which it had possessed as a Territory, for the intention of that legislation was 'to accord Puerto Rico the degree of autonomy and independence normally associated with States of the union.' " [12]

In a recent Supreme Court decision, a 1988 case, the Court treated Puerto Rico as a state in holding that no Federal law preempted Puerto Rico's power to regulate oil prices.[13] The Court said:

> Although Puerto Rico has a unique status in our Federal system . . . the test for Federal pre-emption of the laws of Puerto Rico at issue here is the same as the test . . . for pre-emption of the law of a state.[14]

Appellate Court Cases

The U.S. Court of Appeals for the First Circuit decided several cases in the 1980s in which it treated Puerto Rico as a state. In most of these cases, the court had to determine whether particular Federal statutes applied in the same way as they would have applied to states, and found that they did.

In a 1981 case, the court found no reason to treat Puerto Rico in a manner different from the way it would treat a state. The court held that section 3 of the Sherman Antitrust Act,[15] which prohibits restraints of trade "in any Territory of the united States," applied to Puerto Rico in its commonwealth status.[16] The court said:

> It is fair to assume that the framers of the Sherman Act, had they been aware of the FRA [Federal Relations Act] and subsequent Constitutional developments, would have intended that Puerto Rico be treated as a 'state' under the Act, once Commonwealth status was achieved.[17]

In a 1985 case involving evidence obtained by wiretapping, the court found that the Federal law that allowed evidence of recorded telephone conversations meeting statutory standards,[18] was the controlling law for Federal prosecutions in Puerto Rico.[19] The court held that the Constitution of Puerto Rico, which prohibits wiretapping and the use of wiretapped evidence in court, did not apply. In comparing Puerto Rico to a state, the court said:

> While the creation of the Commonwealth granted Puerto Rico authority over its own local affairs, Congress maintains similar powers over Puerto Rico as it possesses over the Federal states. [Citation omitted.] The congressional intent behind the approval of the Puerto Rico Constitution was that the Constitution would operate to organize a local government and its adoption would in no way alter the applicability of United States laws and Federal jurisdiction in Puerto Rico. [Citations omitted.] When Congress approved the Constitution of Puerto Rico it was simultaneously enacted: "The statutory laws of the United States not locally inapplicable, except as here-

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[10] Id. at 339.

[11] Puerto Rico v. Branstad, 483 U.S.—— 107 S. Ct. 2802 (1987).

[12] 483 U.S. at —— 107 S. Ct. at 2809.

[13] *Puerto Rico Department of Consumer Affairs* v. *Isla Petroleum Corp.*, 485 U.S.—— 56 U.S.L.W. 4307 (1988).

[14] 56 U.S.L.W. at 4308.

[15] 15 U.S.C. § 1 *et seq.*

[16] *Cordova* v. *Chase Manhattan Bank N.A.*, 649 F.2d 36 (1st Cir. 1981)

[17] 649 F. 2d at 42.

[18] 18 U.S.C § 2510 *et seq.*

[19] *United States* v. *Quinones*, 758 F.2d 40 (1st Cir. 1985).

> inbefore or hereinafter otherwise provided, shall have the same force and effect in Puerto Rico as in the United States. . . ." 48 U.S.C. 5 734.[20]

In a civil rights case in 1985,[21] the court viewed Puerto Rico as a state in determining that certain residency rules of the Amateur Sports Council of Puerto Rico did not constitute "state" action that violated the Fourteenth Amendment and a Federal statute.[22] The court found that Commonwealth actions are to be treated as state actions when applying Federal civil rights law.

In another civil rights case in 1987, in which two Puerto Rican police officers were convicted of assaulting and beating three men, the court held that Federal statutes making it a crime under certain conditions to deprive someone of their civil rights[23] applied to Puerto Rico.[24] The court went on to hold that, just as would be the case with a state, the defendants could be prosecuted under both Federal and local law, without violating the constitutional prohibition against trying a person twice for the same crime (double jeopardy) because Puerto Rico and the United States were separate sovereign entities.

> Although the legal relationship between Puerto Rico and the united States is far from clear and fraught with controversy, it is established that Puerto Rico is to be treated as a state for purposes of the double jeopardy clause.

Finally, In a 1988 case, the court concluded that the Immigration and Naturalization Service's policy of seizing airline passengers' tickets as a matter of course, before completing an initial inspection and without any articulable suspicion that the ticket holder was an Illegal alien, violated the Fourth Amendment, which prohibits unreasonable searches and seizures.[25] The case involved a passenger at a Puerto Rico airport, and the court found that both the Fourth Amendment and the right to travel freely applied to Puerto Rico. In a partially concurring opinion, one judge said:

> Puerto Rico's constitutional status is irrelevant to the validity of the challenged process because the requirements of the Fourth Amendment are as fully applicable in Puerto Rico as in the States.[26]

District Court Cases

In a 1980 decision of the United States District Court for the District of Puerto Rico, Puerto Rico received the same treatment a state would have received. The court did not, however, compare Puerto Rico with a state. The court found that the Commerce Clause of the Constitution, which gives the Congress authority to regulate commerce with foreign nations and among the states, applied to Puerto Rico no matter what its technical status.[27] Citing a Supreme Court decision,[28] the court said that it was settled that:

> [R]egardless of the nature of the particular constitutional relationship between Puerto Rico and the United States, the Territorial Clause [which empowers Congress to regulate territories] is a source of congressional power over the island.[29]

CASES TREATING PUERTO RICO IN A MANNER DIFFERENT FROM A STATE

We found only one case during the 1980s in which a Federal court treated Puerto Rico different from the way it would have treated a state. The case was a Supreme Court case in which Puerto Rico challenged its rate of reimbursement under the Aid to Families with Dependent Children (AFDC) program.[30] Puerto Rico argued that the reimbursement rate violated the Fifth Amendment's equal protection guarantee because it was lower for Puerto Rico than for the states.

The court said that the Congress, which was empowered under the Territory Clause of the Constitution[31] to make all necessary rules and regulations respecting a territory, could treat Puerto Rico differently from states. Citing an earlier Supreme Court decision,[32] the Court reiterated: "Congress . . . may treat Puerto Rico differently from States so long as there is a rational basis for its actions." [33] The court cited three rational bases for the statutory classification of Puerto Rico under AFDC:

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[20] 758 F.2d at 43.
[21] 18 U.S.C. § 241, 242 (1982).
[22] 42 U.S.C. § 1983.
[23] 18 U.S.C. § 241, 242 (1982).
[24] *United States* v. *Lopez Andino*, 831 F.2d 1164 (1st Cir. 1987).
[25] Lopez Lopez v. Aran, 844 F.2d 898 (1st Cir. 1988).
[26] 831 F.2D at 1168.
[27] *Sea-Land Service, Inc.* v. *Municipality of San Juan*, 505 F. Supp. 533, 539 (D.P.R. 1980).
[28] *Harris* v. *Rosario*, discussed below.
[29] 505 F. Supp. at 544.
[30] *Harris* v. *Rosario*, 446 U.S. 651 (1980).
[31] U.S. Const., Art. IV, § 3, cl. 2.

> Puerto Rican residents do not contribute to the Federal treasury; the cost of treating Puerto Rico as a state under the statute would be high; and greater benefits could disrupt the Puerto Rican economy.[34]

ANOTHER RELEVANT CASE

In a 1981 case, the First Circuit Court of Appeals found that a statute that applied to "dependencies and insular possessions of the United States" continued to apply to Puerto Rico after it became a commonwealth.[35] The statute was 12 U.S.C. § 632, which gives Federal district courts jurisdiction over certain banking transactions in "dependencies or insular possessions of the United States." In holding that the statute applied to Puerto Rico, the court said:

> Puerto Rico's territorial status ended; of course, in 1952. Thereafter it has been a Commonwealth with a particular status as framed in the Puerto Rican Federal Relations Act. Act of July 13, 1950, Pub. L. 600, § 4, 64 Stat. 319; *see also* Act of July 3, 1952, Pub. L. 447, 66 Stat. 327. However, nothing in this legislation expressly or by necessary implication removed Puerto Rico from the reach of section 632. While Puerto Rico's new status rendered the words 'dependency or insular possession' somewhat obsolete as to it, the language was nonetheless still sufficient, given the historical context, to encompass the reorganized Commonwealth.[36]

[This section has been selectively updated from the 1981 GAO report. Information contained in brackets has been updated.]

SECTION 5.—GOVERNMENTAL ORGANIZATION OF THE COMMONWEALTH OF PUERTO RICO

GOVERNMENTAL STRUCTURES

Although the island's present relationship with the federal government has not been defined precisely, Puerto Rico exercises virtually the same control over its internal affairs as the states. Also, the island's Constitution provides for a government structure similar to that of the Federal Government and the states. In fact, Puerto Rico was the first of the present U.S. territories to have a congressionally approved constitution and locally elected governor.

The island freely manages local affairs and also operates within the broader Federal political system. Presently, like states, Puerto Rico does not exercise responsibilities within the Federal government's purview, such as levying duties or imposts on imports or exports, entering into treaties with foreign governments, coining money, and establishing rules for naturalization.

Commonwealth Constitution Modeled After U.S. and State Constitutions

Most of the Commonwealth Constitution's provisions were adopted directly from the U.S. and state constitutions. Puerto Rico's Constitution provides for three separate independent branches of government—executive, legislative, and judicial—with appropriate checks and balances. The Commonwealth Constitution also includes an extensive Bill of Rights essentially derived from the traditional protections contained in Federal and state constitutions.

Although there is much similarity, the Commonwealth Constitution contains provisions not in the U.S. Constitution. Examples include:

—popular majority ratification of constitutional amendments;
—prohibition of sex discrimination, wire-tapping, and the death penalty;
—jury conviction in a felony case by three-fourths majority vote;
—minority party representation in the legislature equal to each party's elective strength; and

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[32] *Califano* v. *Torres*, 435 U.S. 1 (1978).

[33] 446 U.S. at 651-52.

[34] *Id.* at 652.

[35] *First Federal Savings and Loan Association of Puerto Rico* v. *Ruiz de Jesus*, 644 F.2d 910 (1st Cir. 1981).

[36] Id. at 911.

—employees' rights and protections for equal pay, the work environment, and collective bargaining.

Some of these provisions, however, are present in other Federal laws or in the constitutions or laws of one or more states.

Executive Power Vested With an Elected Governor

The Commonwealth government's executive authority rests with its governor. The governor is responsible for executing Commonwealth laws and can make appointments, grant pardons and reprieves, and approve or disapprove joint resolutions and bills passed by the legislature. The governor must also report annually on the Commonwealth treasury's condition and the proposed expenditures for the ensuing fiscal year and present a message concerning the Commonwealth's affairs when each regular legislative session begins.

The governor is commander-in-chief of the militia, which is the National Guard, and can order it to prevent or suppress rebellion, invasion, or any serious public disturbance. Although the governor can proclaim martial law, the Legislative Assembly must convene immediately and either ratify or revoke the governor's proclamation.

The governor is popularly elected in general elections held every fourth November. A gubernatorial candidate must be at least 35 years old as well as a U.S. citizen and a citizen and bona fide resident of Puerto Rico for the preceding 5 years. No limit exists on the number of terms that the governor can be reelected.

In addition to prescribing the governor's powers, the Commonwealth Constitution establishes various executive departments, headed by secretaries, appointed by the governor with the advice and consent of the Senate. The Constitution also establishes the position of Secretary of State, whose appointment must be approved by both legislative houses. The Secretary of State succeeds the governor in case of a permanent or temporary vacancy in that office.

Executive branch responsibilities are similar to those in states, but more extensive. For example, they include: education, health, police and fire protection, telephone communications, electricity, water, and maritime transportation. The executive branch presently includes the Office of the Governor, [15 departments, 42 executive agencies, and 52 public corporations, as shown in table 5.1.]

TABLE 5.1—ORGANIZATION OF THE EXECUTIVE BRANCH OF PUERTO RICO

- Executive Departments:
  - Justice
  - Treasury
  - Health
  - Education
  - Labor and Human Resources
  - Agriculture
  - State
  - Transportation and Public Works
  - Commerce
  - Social Services
  - Consumer Affairs
  - Natural Resources
  - Housing
  - Anti-Addiction Services
  - Recreation and Public Sports
- Executive Agencies and Offices:
  - State Elections Commission
  - Forensic Sciences Institute of Puerto Rico
  - Civil Rights Commission
  - Office of the Insurance Commissioner
  - Office of the Commissioner of Financial Institutions
  - Health Services and Facilities Administration
  - Minimum Wages Commission
  - Office of Veterans Affairs
  - Agricultural Development Administration
  - Agricultural Services Administration

TABLE 5.1—ORGANIZATION OF THE EXECUTIVE BRANCH OF PUERTO RICO—Continued

- Industrial Tax Exemption Office
- Traffic Safety Commission
- Office of the Administration of the State Insurance Fund
- Juvenile Institutions Administration
- Industrial Commission
- Public Service Commission
- Office of Human Development
- Board of Appeals on Construction and Land Subdivisions
- Commission on Investigation, Prosecution and Appeals
- Regulations and Permits Administration
- Puerto Rico Administration for Federal Government Affairs
- Puerto Rican Commission for the Celebration of the Quintecentennial Celebration of the Discovery of America and Puerto Rico
- Parole Board
- Corrections Administration
- Office of the Inspector of Cooperatives
- Cooperative Development Administration
- General Services Administration
- Office of Government Ethics
- Horse Racing and Equine Industry Administration
- Labor Relations Board
- Sugar Board
- Municipal Complaints Hearing Commission
- Municipal Services Administration
- Puerto Rico Police
- Puerto Rico National Guard
- Economic Development Administration
- Fire Department
- Central Office of Personnel Administration
- Rural Housing Administration
- Board of Appeals of the Personnel Administration System
- Puerto Rico Government Employees' Retirement System
- Teachers' Retirement Board

Public Corporations:

- Corporation for the Transfer of Technology
- Corporation for Correctional Enterprises
- Land Administration
- Cooperative Development Company
- Corporation for the Musical Arts
- Puerto Rico Corporation of the Musical Scenic Arts
- Corporation of the Puerto Rico Conservatory of Music
- Corporation of the Symphony Orchestra of Puerto Rico
- Public Building Authority
- Medical Services Administration of Puerto Rico
- Right to Work Administration
- Tourism Company of Puerto Rico
- Agricultural Credit Corporation
- Rural Development Corporation of Puerto Rico
- Agricultural Insurance Corporation
- Port Authority
- Metropolitan Bus Authority
- Highway Authority
- Corporation of Industries of the Blind, Mentally Retarded and Other Incapacitated Persons
- Industrial Development Company
- Puerto Rican Institute of Arts, Cinematography and Television
- Corporation for Urban Renewal and Housing
- Housing Bank and Financing Agency

TABLE 5.1—ORGANIZATION OF THE EXECUTIVE BRANCH OF PUERTO RICO—Continued

Government Development Bank of Puerto Rico
Municipal Finance Agency of Puerto Rico
Recreational Development Company
University of Puerto Rico
Agricultural Experimental Station
Agricultural Extension Service
Corporation for the Conservation and Administration of the Simon de la Torre Cemetary
Telephone Authority
Puerto Rican Public Broadcasting Corporation
Puerto Rican Telephone Company
Corporation for the Technological Development of the Tropical Resources of Puerto Rico
Sugar Corporation

Public Corporations:

Land Authority
Corporation of the Fine Arts Center of Puerto Rico
Institute of Puerto Rican Culture
Communications Authority of Puerto Rico
Aqueduct and Sewer Authority
Electric Energy Authority of Puerto Rico
Puerto Rico Shipping Authority
Administration for the Compensation of Automobile Accidents
Corporation for the Cardiovascular Center of Puerto Rico and the Caribbean
Economic Development Bank of Puerto Rico
Puerto Rico Authority for Solid Waste Management
Commercial Development Company
Authority for the Finance of Industrial, Medical, Educational and Control of Environmental Contamination Facilities
Puerto Rico Corporation for the Development and Administration of Lake, River and Marine Resources
Culebra Conservation and Development Authority
Puerto Rico Corporation for the Development of Mineral Resources
Puerto Rico Authority for the Finance of Infrastructure

Source: Commonwealth of Puerto Rico Budget for Fiscal Year 1989-90, March 1989, vol. I-III

Popularly Elected Bicameral Assembly Executes Legislative Functions

The Commonwealth Constitution provides that "The legislative power shall be vested in a Legislative Assembly . . . ." The assembly is bicameral and convenes annually from the second Monday in January through April. Each house is led by an officer—the Senate by the President and the Rouse of Representatives by the Speaker. Although special sessions may be called only by the governor, regular sessions may be extended indefinitely by joint resolution.

A majority of both houses must approve bills before they are submitted to the governor, who has 10 days to sign the bill into law or return it with objections. If the governor does not act within 10 days the bill becomes law. Also, a returned bill can become law if two-thirds of each house approve it.

The Legislative Assembly also has the power to create, consolidate, or reorganize executive departments and define their functions. Further, it has broad authority over local municipalities. The assembly is also responsible for approving the Commonwealth's budget and determining how the Commonwealth and the municipalities impose and collect taxes. Moreover, the assembly may propose constitutional amendments by concurrent resolution, approved by at least two-thirds of each house.

Legislative Assembly members are popularly elected in general elections and serve 4-year terms concurrent with the governor. Legislators must read and write Spanish or English and be citizens of the United States and Puerto Rico. Minimum age for senators is 30 years old and representatives 25 years. Also, all legislators must have resided on the island at least 2 years immediately prior to election.

The Legislative Assembly consists of 27 senators and 51 representatives. Two senators are elected from each of 8 senatorial districts, and 11 others compete for "at large" seats. Representatives are elected from 40 districts, 1 member from each, and 11 "at large."

Additionally, in certain situations if more than two-thirds of the members in either house are elected from a single party, such number of members may be increased so that the total number of minority members can be 9 in the Senate and It in the House. With more than one minority party, seats are apportioned according to each group's electoral strength. This unique constitutional provision has been used to assure representation of minority parties in the legislature approximating their voting strength on an island-wide basis.

The Commonwealth Constitution also establishes an independent controller who is principally responsible to the Legislature. The controller, appointed by the governor with consent of the Legislative Assembly to a 10-year term, is charged with auditing all revenues, accounts, and expenditures of the Commonwealth, its agencies and instrumentalities, as well as local municipalities.

Unified Judicial System Mandated

The Commonwealth Constitution provides for a unified judicial system for purposes of jurisdiction, operation, and administration. The Constitution vests judicial power in a Supreme Court and any courts as may be established by law. It also empowers the Legislative Assembly to create and abolish courts, except for the Supreme Court, in a manner not inconsistent with the Constitution, and to determine courts' venue and organization.

The assembly exercised this authority by passing the Judiciary Act of 1952, which vested judicial power in a General Court of Justice—composed of the Supreme Court and the Court of First Instance. The Supreme Court is almost exclusively a court of appellate jurisdiction although it does have original jurisdiction to hear habeas corpus petitions and other causes and procedures conferred on it by law. The Court can hold laws unconstitutional, but only by majority of the Court's justices. The court is authorized to adopt rules for administering Puerto Rico courts and rules of evidence and civil and criminal procedure, subject to legislative approval. The court's decisions may be appealed to the U.S. Supreme Court in the same kinds of cases that can be appealed from the highest state courts.

Currently, Puerto Rico law provides that the Supreme Court have seven justices—a chief justice and six associate justices—appointed by the governor upon the advice and consent of the Senate. Justices must be citizens of Puerto Rico and the United States, residents of Puerto Rico for at least 5 years prior to appointment, and admitted to practice law in Puerto Rico at least 10 years prior to appointment. Moreover, justices serve indefinite terms, and the size of the court can be changed "only by law upon request of the Supreme Court." Furthermore, justices cannot participate in political campaigns, contribute to political parties, or hold elected office.

The Court of First Instance has original jurisdiction over civil and criminal proceedings and is comprised of two divisions—the superior court and the district court. Although the 1952 act specifies cases to be heard in these courts, each division can hear a case if the concerned parties and the judge agree. The superior court also hears appeals from final judgments of the district court. Court of First Instance judges are appointed by the governor for specified terms with advice and consent of the Senate.

As mentioned earlier, the U.S. district court for the district of Puerto Rico hears Federal cases. Appeals from this court are treated essentially like those from other Federal district courts. The island's official courtroom language is Spanish, except in the Federal district court where English is required. Although attempts have been made to allow certain proceedings in Spanish, legislation has not been enacted.

PUBLIC CORPORATIONS

Puerto Rico's 52 public corporations are governmental entities of the Commonwealth, with varying degrees of independence from the central government, particularly with respect to the custody of funds. Most public corporations are governed by boards appointed by the governor with the advice and consent of the Senate, but some public corporations are subsidiaries or departments of the central government.

Most public corporations obtain revenues from charges for services or products, but many are subsidized by the central government. The larger public corporations finance capital improvements through the sale of bonds.

Most of the island's public corporations provide public utilities or social services, in some cases performing services normally associated with the private sector in the states. Examples follow.

—*The Electric Power Authority* owns and operates generating and distribution facilities which supply 99 percent of all electric power consumed in Puerto Rico. [For fiscal year 1989, Puerto Rico budgeted $1.1 billion for this agency.]

—*The Government Development Bank* is the financial adviser and fiscal agent for the Commonwealth government, the public corporations, and the municipalities, particularly in the issuance of bonds and notes. To aid in the island's economic development, the bank also makes loans to public corporations as well as private enterprises. [For fiscal year 1989, Puerto Rico budgeted $630 million for this agency.]

—*The Telephone Authority* purchased the Puerto Rico Telephone Company from the International Telephone and Telegraph Corporation in 1974. The authority operates the island's principal telephone system. Areas not covered by this system are served by another public corporation, the Communications Authority. [For fiscal year 1989, Puerto Rico budgeted $574 million for this agency.]

—*The Public Buildings Authority* plans, acquires, leases, and constructs office buildings, schools, courthouses, police and fire stations, warehouses, hospitals, and related facilities for lease to government agencies. [For fiscal year 1989, Puerto Rico budgeted $343 million for this agency.]

—*The Industrial Development Company* participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to manufacturers. [For fiscal year 1989, Puerto Rico budgeted $100 million for this agency.]

—*The University of Puerto Rico*, with more than 50,000 students, is the island's largest institution of higher learning. [For fiscal year 1989, Puerto Rico budgeted $454 million for the university.]

—*The Sugar Corporation* was created in 1973 to consolidate ownership and management of the Commonwealth's interests in the sugar industry. These interests consist primarily of owned and leased land, mills, and refineries. The corporation grows its own cane, buys cane grown by private firms, processes the cane, and sells the crude, refined sugar, and molasses. [For fiscal year 1989, Puerto Rico budgeted $188 million for this agency.]

—*The Urban Renewal and Housing Corporation* carries out activities related to (1) providing housing for moderate income families, (2) federally aided public housing, (3) urban renewal, and (4) other housing activities financed by Commonwealth appropriations. [For fiscal year 1989, Puerto Rico budgeted $269 million for this agency.]

—*The Ports Authority* owns and operates the island's major airport and seaport facilities. [For fiscal year 1989, Puerto Rico budgeted $98 million for this agency.]

—*The Maritime Shipping Authority* operates three shipping lines, acquired in 1974, serving Puerto Rico and the U.S. mainland. [For fiscal year 1989, Puerto Rico budgeted $388 million for this agency.]

—*The Land Administration* is responsible for the use of land. It acquires and maintains land reserves for developing agricultural and manufacturing facilities and for constructing housing, commercial, health, school, recreational, and other public facilities. [For fiscal year 1989, Puerto Rico budgeted $58 million for this agency.]

—*The Housing Bank and Finance Agency* is principally engaged in insuring and servicing mortgages originated by the Urban Renewal and Housing Corporation. [For fiscal year 1989, Puerto Rico budgeted $316 million for this agency.]

Table 5.2 presents financial data on selected public corporations as of 1979. Although not fully comparable due to accounting differences, the data provides some insight as to the size of these activities.

Table 5.2.—FINANCIAL DATA ON SELECTED PUBLIC CORPORATIONS FOR FISCAL YEAR 1989

[In millions of dollars]

Public corporations	Total assets	Total liabilities	Net assets	Fiscal year 1979 revenues
Electric Power Authority	$1,940.4	$1,671.4	$269.0	$669.8
Highway Authority	1,482.9	727.9	755.0	134.7
Government Development Bank	1,301.1	1,199.8	101.3	110.5
Aqueduct and Sewer Authority	991.3	332.8	658.5	88.7
Telephone Authority	782.6	751.0	31.6	212.0
Public Buildings Authority	512.0	430.1	81.9	60.3

Table 5.2.—FINANCIAL DATA ON SELECTED PUBLIC CORPORATIONS FOR FISCAL YEAR 1989—Continued

[In millions of dollars]

Public corporations	Total assets	Total liabilities	Net assets	Fiscal year 1979 revenues
Industrial Development Company	395.6	134.2	261.4	27.5
University of Puerto Rico	383.4	329.7	53.7	207.0
Sugar Corporation [1]	353.2	415.6	(62.4)	80.1
Urban Renewal & Housing Corporation	330.4	455.8	(125.4)	65.5
Ports Authority	254.3	124.8	129.5	37.5
Maritime Shipping Authority	179.9	211.9	(32.0)	232.4
Land Administration	143.8	31.1	112.7	5.8
Housing Bank & Finance Agency	120.7	95.0	25.7	9.9
Communications Authority	72.7	59.7	13.0	17.9
Municipal Finance Agency	47.7	47.3	0.4	3.1
Totals	9,292.0	7,018.1	2,273.9	1,962.7

[1] Fiscal year 1978 data

[Table 5.3 presents financial data on seven of the above selected public corporations as of 1987. Although not fully comparable due to accounting differences, the data provides some insight as to the size of these activities.]

[Table 5.3]—UPDATED FINANCIAL DATA ON 11 PUBLIC CORPORATIONS FOR FISCAL YEAR 1987

[In millions of dollars]

Public corporations	Total assets	Total liabilities	Net assets	Fiscal year 1987 Revenues
Government Development Bank	$5,687.6	$5,304.0	$383.5	$383.6
Highway Authority	2,524.3	710.4	1,813.9	70.0
Electric Power Authority	2,552.8	2,218.9	333.9	860.5
Aqueduct and Sewer Authority	2,040.2	735.7	1,304.6	259.8
Telephone Authority	1,296.6	937.9	358.8	485.1
Public Buildings Authority	1,075.2	803.7	271.5	122.2
Industrial Development Company	574.8	195.4	379.4	50.1
Ports Authority	352.4	154.3	198.1	60.7
Maritime dipping Authority	214.3	424.4	(210.1)	311.8
Communications Authority	186.7	122.8	63.9	53.4
Land Authority	63.6	20.0	43.6	37.6

Source Annual reports for each public corporation, and the Fiscal Year 1989-90 Budget for the Commonwealth of Puerto Rico

Municipalities Are the Only Level of Local Government

The Commonwealth Constitution empowers the Legislative Assembly to create, abolish, consolidate, and reorganize municipal subdivisions. Municipalities cannot be abolished or created, however, unless a majority of their voters ratify the legislation. The Legislative Assembly also determines how municipalities can impose and collect taxes and authorizes them to develop programs and create agencies for the general welfare.

Municipalities are Puerto Rico's only local political subdivision. Each of the island's 78 municipalities has a mayor and a municipal assembly. Located in both urban and rural areas, the average population for the municipalities is about 25,000 and only 5 have populations exceeding 100,000. Metropolitan San Juan has a population of about one million persons.

Each municipality has a mayor and assembly, popularly elected to serve terms concurrent with the governor and Commonwealth legislature. To qualify for municipal office, a candidate must be able to read and write Spanish or English and be a resident and qualified voter of that municipality. Each municipality can levy certain sales taxes, but responsibilities vary.

Although the Commonwealth government provides most government services, the municipalities are responsible for local administration of services, such as street cleaning, garbage collection, and some public works. To a limited extent, the municipalities share responsibility for education and health by providing various services such as drivers for school buses and ambulances. Moreover, seven municipalities augment the Commonwealth police with their own local police forces, and two municipalities provide their own electric power because they are too remote from facilities of the Electric Power Authority.

The municipalities carry out their responsibilities primarily with commonwealth and Federal Government funds, as well as some self-generated revenues. Further, the Commonwealth legislature exercises certain supervisory responsibilities over the municipalities' budgeting and fiscal affairs. For fiscal year 1980, the estimated budget for the municipalities amounted to $540 million, with $274 million coming from commonwealth and local sources, and the remaining $266 million coming from the federal government, primarily for the comprehensive employment and training program, community development, and local public works. The largest combined municipal budget was San Juan's, which totalled $165 million—$88 million from island sources and $77 million from the Federal government.

Most municipalities had budgets ranging between $1 million and $2 million, exclusive of Federal funds. The more significant sources of local revenue were the municipal subsidies from the Commonwealth; the property-taxes levied by the municipalities and collected by the Commonwealth; and the municipal shares of the Puerto Rican lottery receipts, cigarette taxes, and Electric power Authority rebates. Municipalities also raised limited revenues from business licenses and from renting municipal facilities to the Commonwealth government.

LEGAL AND POLITICAL STRUCTURES

Puerto Rico Law Is A Blend of Civil and Common Law Traditions

Prior to becoming a U.S. territory, Puerto Rico law was based on Spanish civil law—Spain's version of the civil law system developed primarily in continental Europe under the influence of Roman Law. In England and subsequently in nearly all of the United States, common law prevailed.

Civil law and common law differ principally in the way law is created. In a civil law jurisdiction, the legislature establishes laws primarily by enacting codes with broad provisions. Civil law courts look to codes as primary sources of law. Court decisions usually are neither primary sources of law nor binding on other courts, even though they are consulted as aids in the decisionmaking process.

Civil law courts generally do not create the law but only apply it, and common law courts traditionally are a principal lawmaking body. Common law court decisions of a jurisdiction's highest court are binding on itself and the lower Courts in the same jurisdiction. Although statutes and codes are primary sources of law as in civil law jurisdictions, common law legislation is usually more specific than civil law codes.

In practice, civil and common law systems often are not as dissimilar as they appear. Although civil law courts base their decisions principally on code provisions, they may rely on and follow consistent higher courts' decisions. Moreover, in instances where a code provision does not specifically address the matter in controversy, the distinction between applying the law and creating it may be insubstantial. At the same time, much of common law is legislatively rather than judicially created. This is particularly true of U.S. Federal law, since no U.S. federal general common law exists.

Since becoming part of the united States, significant aspects of Anglo-American Common Law have been added to or replaced Puerto Rico's Spanish civil law. This synthesis to a mixed civil and common law jurisdiction began soon after Puerto Rico became a territory. Although the 1900 Foraker Act established a three-member commission to compile and revise Puerto Rico's laws, it:

> was not appointed to sweep away the legal system of the island, but rather to preserve those native institutions which have given evidence of vigor and growth, and to adapt them to the fundamental principles of American Law.

Subsequently, the Puerto Rican legislature preserved two of the five principle Spanish civil law codes and replaced three others with codes based on common law. Although modified over the years, the Spanish Civil Code and to some extent the Code of Commerce are still in force. The Spanish Penal Code was replaced by one adopted from that of Montana. The Spanish Code of Civil Procedure and, in great measure, the Code of Criminal Procedure were replaced by ones adopted from those used by Idaho and California, respectively.

The blending of civil and common law is evident in Commonwealth Supreme Court decisions. For example, that Court has frequently held that the primary source of law is written law promulgated by the legislature—a fundamental civil law characteristic. However, as in common law jurisdictions, Puerto Rico's Supreme Court, almost since its establishment, has relied on its previous decisions as a basis for deciding cases and has held itself and lower courts bound by those decisions.

Although the United States is essentially a common law country, civil law is not unknown. After the American Revolution there was considerable support for adopting French civil law. Although this did not occur subsequent acquisitions of civil law and mixed jurisdictions, which later became states, led to a continued presence of civil law. For example, in such states as Texas, California, Arizona, and New Mexico the civil law doctrine of community property, giving spouses certain rights in marital property, still is in force.

Louisiana is the only state in which a civil code is still fully in force. Like Puerto Rico, civil law has been in use in Louisiana for several hundred years, but common law has also been a strong influence. For example, unlike pure civil law jurisdictions, consistent decisions of the Louisiana Supreme Court are consulted and followed by Louisiana state courts.

Constitution Assures Citizens' Rights in Collective Decisions

The Commonwealth Constitution establishes a democratic system of government and states that this system is fundamental to the Puerto Rican community. It emphasizes that the peoples' will is the source of public power and political order is subordinate to the rights of man, while assuring citizens' free participation in collective decisions. The Constitution provides for general elections every 4 years. At that time, the governor, the Legislative Assembly, municipal officials, and any other officers the legislature may determine are elected.

Although matters concerning the electoral process are left to legislative determination, the Constitution provides that every person over 18 years old is entitled to vote, and the inability to read or write and nonownership of property cannot disqualify a voter. Although regulation of elections and the registration of political parties and voters are also left to legislative determination, this power is limited by constitutional provisions guaranteeing protections for citizens and political parties.

Electoral Law Governs Political Process

The 1977 "Puerto Rico Electoral Act," as amended, which replaced prior electoral laws, presently governs the island's electoral process. The act (1) provides for a Commonwealth Election Commission and an Electoral Review Board; (2) details procedures for voting and voter registrations; (3) establishes regulations for political parties, candidates' eligibility, party funding, and political contributions; (4) sets penalties for violations; and (5) provides for citizens' protections and rights in the political process.

The Commonwealth Election Commission organizes and supervises the electoral process. The Commission is composed of a general administrator, who acts as its chairman, and electoral commissioners from each political party. The administrator is appointed by the governor for a 10-year term with the consent of the Legislative Assembly. Commissioners are also appointed by the governor following petitions from each party.

The Commonwealth Election Commission also regulates local election commissions. These permanent local commissions are composed of a chairman and regular members from each political party. Each polling place is staffed by a poll board comprised of one inspector from each political party and any other participating candidate or organization.

The Electoral Review Board investigates matters concerning the electoral process, candidate eligibility requirements, and election results. The board has three members, appointed to 10-year staggered terms by the governor, with consent of the Legislative Assembly. Although the board's findings of fact are final, appeals on questions of law maybe taken to the Commonwealth Supreme Court.

The electoral act altered Puerto Rico's voting system. Prior to 1980 all voters gathered in polling stations by a given hour, and the doors were closed until all ballots were cast. Beginning in 1980, however, all voters were to be permitted to cast ballots at any time between prescribed hours. Because a large number of registered voters did not obtain identification cards, this system could not be fully implemented for the 1980 election. According to a Commonwealth official, however, those without identification cards were allowed to vote at a prescribed hour under procedures applied in the past.

ROLE IN U.S. FEDERAL SYSTEM

Puerto Rican Federal Relations Act Contains Present Basic Arrangements

Current fundamental arrangements between the island and the federal government are described in the Puerto Rican Federal Relations Act, as amended. Among other provisions this act continues Puerto Rico's exemption from certain U.S. internal revenue laws. Excise taxes on certain Puerto Rican goods domestically produced and transported tc the United States are returned to the island treasury, as are U.S. tariffs on foreign goods imported into the island.

Provisions for U.S. citizenship and free trade between Puerto Rico and the states are also continued. Puerto Rico has control of all public lands and buildings, highways, harbor areas, streams, and submerged lands not reserved for Federal Government purposes. A resident commissioner continues to represent island residents in the united States. The act also provides that U.S. laws not locally inapplicable shall apply equally to Puerto Rico and describes the U.S. district court's jurisdiction to hear Federal cases.

National Political and Legislative Participation Has Grown But Remains Limited

Puerto Ricans have been American citizens since 1917, but they cannot vote in presidential elections unless they are registered to vote in a state or the District of Columbia. Residents, however, participate in choosing presidential candidates through the national conventions and presidential primaries. Additionally, Puerto Rico residents elect a resident commissioner to the united States but do not send senators or representatives to the Congress.

In 1970, an advisory group appointed by the president and Puerto Rico's governor studied extending islanders the right to vote in presidential elections. It concluded that such enfranchisement was not incompatible with Commonwealth status because of common citizenship. Although the group recommended that the vote be granted if residents chose so in referendum, a direct vote by island residents has not been taken.

Residents Have No Vote for President But Help Choose Candidates

Even though Puerto Ricans and other territorial domiciliaries cannot vote in national elections, they help choose presidential candidates. Puerto Ricans have traditionally participated in both the Republican and Democratic national conventions. Although the island's delegations have grown since the original two Republican delegates and six Democratic delegates in 1904, the number of island delegates has been determined differently from states.

The Republican party allocates three delegates for each congressional district, but territories' delegations are determined arbitrarily. Puerto Rico's delegation varied until 1964 when it was allocated five members. In 1976 the island was allocated 8 seats, and in 1980 the delegation was further increased to 14 members.

Democratic convention delegations from the states and the District of Columbia are calculated on the basis of (1) votes cast for the Democratic presidential candidate in the last three elections and (2) the population as measured by the electoral vote. Between 1904 and 1960, Puerto Rico was allocated six delegates to each Democratic convention. In 1964 and 1968 Puerto Rico had an eight-member delegation, and in 1972 it decreased to seven. In 1976 the part of the formula measuring population by electoral votes was applied to Puerto Rico. Because the island was assumed to have 4 electoral votes its delegation increased to 22 members. Puerto Rico's delegation further increased in 1980 to 41 delegates, the 27th largest in attendance.

While Puerto Rico has traditionally participated in national conventions, early in 1980 the island held its first presidential preference primaries. Previously, island delegates were chosen by caucus without direct voter participation. The Republican primary was held in February and the Democratic primary a month later. Combined turnout was substantial, with about I million eligible voters participating.

Residents Have Some Representation in the Congress

Puerto Rico residents do not have voting representation in the Congress, because this right is constitutionally guaranteed only to state residents. They do, however, elect a resident commissioner to the united States, who in many respects serves as a member of the House of Representatives.

The first commissioner was elected in November 1900 but was not permitted on the House of Representatives' floor until June 1902. In February 1904, he was granted the same powers as delegates from other territories. The resident commissioner can introduce legislation and speak in committee or on the floor. Although allowed to vote in committee beginning in 1970, the resident commissioner cannot vote on the House floor.

[This section has been updated from the 1981 GAO report.]

Section 6.—Governmental Finances In Puerto Rico

Government in Puerto Rico includes the Commonwealth central government (with its 52 public corporations) and 78 municipalities. Unlike most states, the great majority of governmental functions are administered and financed by the central government and its public corporations and limited responsibilities have been delegated to the municipalities.

We analyzed the Commonwealth's 1989 revenue and expenditure patterns and contrasted them with the averages for state and local governments in the 50 states and the District of Columbia. We also examined trends in governmental debt.

As a percent of total revenues, and excluding the sales of goods and services, the Commonwealth and its municipalities rely more heavily on corporate and individual income taxes and less on property taxes than the average of all state and local governments. Also, as a percent of total expenditures, spending patterns of the Commonwealth were roughly comparable (excluding the municipalities and the commercial activities of public corporations) with those of state and local governments, though spending for education was less in Puerto Rico.

The level of total debt per capita is about that of state and local governments, but excluding the debt of public corporations it is less than state and local borrowing. The debt of these public corporations is generally financed by the revenues of these corporations, similar to private corporate borrowing. However, since they are governmental entities, interest on their bonds is tax-exempt.

While comparisons with state and local revenues, expenditures, and debt levels provide a useful context for describing Puerto Rico's government finances, the comparison is a rough one at best, for a number of reasons. First, some financial classifications of revenues by source, and expenditures by purpose, were not comparable because such data were not readily available. Second, the Commonwealth's governmental activities in some respects, such as supplying agriculture credit, correspond more closely to those of the Federal Government than those of state and local governments. And finally, differences in the pattern of Commonwealth revenues and expenditures and the averages for state and local governments may not necessarily be significant, because wide variations exist among the states.

We have not calculated the burden of taxes and debt on residents of Puerto Rico to compare them to those in states and localities because a very large proportion of taxes collected are ultimately paid by foreign owners and customers of Puerto Rican business. Consequently, expressing taxes as a percent of residents' personal income would substantially overstate resident tax burdens. We have computed tax and debt amounts per capita, but these should not be interpreted as resident tax and debt burdens.

REVENUE SOURCES

We analyzed Puerto Rico's revenues in two ways, first by including its public corporations, and then without. When the public corporations are included, Puerto Rico's most important revenue sources are sales of goods and services (36 percent) individual and corporate income taxes (19 percent) Federal funds (17 percent) and excise taxes (10 percent). Table 6.1 summarizes revenues by source for Puerto Rico (1989) and state and local governments (1987).

TABLE 6.1—TOTAL AND PER CAPITA REVENUES BY SOURCE—PUERTO RICO CONTRASTED WITH STATE AND LOCAL GOVERNMENTS

[In millions of dollars]

Revenue source	Puerto Rico (1989 estimated) [1]			States (1981) [2]		
	Amount	Per capita	Percent of total	Amount	Per capital	Percent of total
Sales of goods and services	$3,747	$1,135	36	$49,810	$205	6
Individual income tax	923	280	9	83,681	344	10
Corporate income tax	1,038	315	10	22,672	93	3
Sales tax	1,072	325	10	144,293	593	17
Property tax	282	85	3	121,227	498	14
Federal funds [3]	1,770	536	17	114,996	472	14
All other revenue sources	1,624	492	16	305,911	1,257	36

TABLE 6.1—TOTAL AND PER CAPITA REVENUES BY SOURCE—PUERTO RICO CONTRASTED WITH STATE AND LOCAL GOVERNMENTS—Continued

[In millions of dollars]

Revenue source	Puerto Rico (1989 estimated) [1]			States (1981) [2]		
	Amount	Per capita	Percent of total	Amount	Per capital	Percent of total
Total	10,456	3,168	100	842,590	3,462	100

[1] Includes public corporations and municipalities.

[2] Includes local governments and the District of Columbia.

[3] Includes Federal grants and intergovernmental transfers.

Source: Puerto Rico figures were prepared by the Governor's Economic Advisory Council. State figures are from the Census Bureau's ***Government Finances in 1986–87.***

The sales of various goods and services, at 36 percent of the total, comprise the largest share of Puerto Rico's revenues. This is high compared with the states and localities (6 percent) because of the many public corporations owned by the Commonwealth, such as electric power, telephone service, various credit corporations, and sugar marketing. For state and local governments, "sales of goods and services" consists of five categories of revenues: government owned and operated water, electric, gas, transit systems, and liquor store receipts. While on average this is a relatively small source of revenue, there is wide variation among the states, ranging from as much as $894 per capita (24 percent of total revenue) in Nebraska to as little as $50 per capita (1 percent of total revenue) in Rhode Island.

In contrast, the category of "all other revenue sources" for state and local governments is 36 percent and 16 percent for Puerto Rico. For states and localities, this includes a significant amount of revenues generated by commercial activities that Puerto Rico categorizes as the sales of goods and services.

We were unable to sort out the differences to make these two categories comparable between Puerto Rico and states and localities. Furthermore, revenues from the sales of goods and services may not be available for general government expenses because (1) they may be restricted for the use of a particular enterprise or fund, and (2) the revenues generated are partly offset by the cost of producing or delivering the goods and services sold. Such costs are not shown in table 6.1 and no information was readily available about restrictions on use of revenues from sales. Therefore, we recomputed table 6.1 to exclude the sales of goods and services, as shown in table 6.2.

TABLE 6.2—TOTAL AND PER CAPITA REVENUES BY SOURCE—PUERTO RICO CONTRASTED WITH STATE AND LOCAL GOVERNMENTS [1]

[In millions of dollars]

Revenue source	Puerto Rico (1989 estimated) [2]			States (1987) [3]		
	Amount	Per capita	Percent of total	Amount	Per capita	Percent of total
Individual income tax	$923	$280	19	$83,621	$344	11
Corporate income tax	1,038	315	22	22,672	93	3
Sales tax	1,072	325	22	144,293	593	18
Property tax	282	85	6	121,227	498	15
Federal funds	[4] 1,126	341	24	114,996	472	14
All other revenue sources	434	101	7	305,911	1,257	39
Total	4,775	1,447	100	792,780	3,257	100

[1] Excludes sales of goods and services.

[2] Includes municipalities.

[3] Includes local governments and the District of Columbia.

[4] Includes Federal grants and intergovernmental transfers.

Source: Puerto Rico figures were prepared by the Governor's Economic Advisory Council. State figures are from the Census Bureau's ***Government Finances in 1986–87.***

Table 6.2 shows that Puerto Rico relies more heavily on individual and corporate income taxes (41 percent) compared with an average of 14 percent for states and localities. Also, Puerto Rico relies less on the use of the property tax than states and localities do on average (6 percent versus 15 percent).

Total revenues, including public corporation revenues, as a percent of gross product for Puerto Rico was 57 percent (it was 26 percent when corporation revenues are excluded). For the states, total revenues as a percent of gross national product was 19 percent when the revenues of utilities and liquor stores are included, and 18 percent when they are not.

EXPENDITURES

We also analyzed Puerto Rico's expenditures, both with and without the commercial activities and public utilities. Taken together, commercial activities and utilities are Puerto Rico's largest expenditures. Also, the Commonwealth spends in total about the same per capita as other state and local governments. Table 6.3 compares expenditures by function for Puerto Rico (1989 estimated) and the states and localities (1987).[1]

TABLE 6.3—TOTAL AND PER CAPITA EXPENDITURES BY FUNCTION—PUERTO RICO CONTRASTED WITH STATE AND LOCAL GOVERNMENTS [1]

[In millions of dollars]

Expenditure category	Puerto Rico (1989 estimated) [1]			States (1987) [2]		
	Amount	Per capital	Percent of total	Amount	Per capital	Percent of total
Education	$1,552	$470	16	$229,932	$945	30
Miscellaneaus commercial	1,496	453	15	3,228	13	([3])
Public utilities	1,326	402	13	65,509	269	8
Health/hospitals	732	222	7	56,972	234	7
Transportation	592	179	6	59,820	24	8
Housing and community development	574	174	6	11,766	48	2
Public safety	570	173	6	56,551	233	7
Government administration	419	127	4	34,896	143	5
Interest on general debt [4]	368	112	4	1,816	172	5
Natural resources	367	111	4	9,738	40	1
Public welfare	357	108	4	80,090	329	10
Sewerage	287	87	3	14,862	61	2
Parks and recreation	103	31	1	10,978	45	1
Social insurance administration	81	25	1	2,752	11	([3])
Other and unallocable [5]	981	297	10	93,854	386	12
Total	9,804	2,971	100	772,864	3,175	100

[1] Includes Commonwealth expenditures but not municipalities' expenditures.

[2] Includes state and local government expenditures.

[3] Less than 1 percent.

[4] Includes agriculture ($171 million in Puerto Rico).

[5] Includes interest of miscellaneous commercial activities ($194 million in Puerto Rico).

Source: Puerto Rico figures were prepared by the Governor's Economic Advisory Council. State figures are from the Census Bureau's *Government Finances in 1986–87.*

When the commercial activities and utilities are excluded, we find that although the spending patterns in Puerto Rico and the states are roughly comparable in many categories, there are several exceptions. For example, spending on education in Puerto Rico is 23 percent of total expenditures, compared with 33 percent in the states, and 5 percent on welfare, compared with 11 percent in the states (see table 6.4).

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[1] The expenditures shown for Puerto Rico include only those of the central government and public corporations while those shown for the states include local government expenditures. Puerto Rico municipal expenditures were not readily available for 1989. In 1982, for which the latest Census Bureau data were available, municipal expenditures were $291 million compared to the Commonwealth's expenditures of $5.7 billion (about 5 percent). The expenditures for public corporations and other central government agencies have been reclassified in order to correspond more closely to the Census Bureau's classification scheme.

TABLE 6.4—TOTAL AND PER CAPITA EXPENDITURES BY FUNCTION—PUERTO RICO CONTRASTED WITH STATE AND LOCAL GOVERNMENTS [1]

[In millions of dollars]

Expenditure category	Puerto Rico (1989 estimated) [1]			States (1987) [2]		
	Amount	Per capita	Percent of total	Amount	Per capita	Percent of total
Education	$1,552	$470	23	$229,932	$945	33
Health/hospitals	732	222	11	56,972	234	8
Transportation	59	179	9	59,820	246	8
Housing and community development	574	174	8	11,766	48	2
Public safety	570	173	8	56,651	233	8
Government administration	419	127	6	34,896	143	5
Interest on general debt	368	112	5	41,816	172	6
Natural resources [4]	366	111	6	9,738	40	1
Public welfare	357	108	6	80,090	329	11
Sewerage	287	87	4	14,862	61	2
Parks and recreation	103	31	2	10,978	45	2
Social insurance administration	81	25	1	2,752	11	(3)
Other	787	238	12	93,854	386	13
Total	6,788	2,057	100	704,127	2,893	100

[1] Includes Commonwealth expenditures but not municipalities' expenditures. It also excludes commercial activities and utilities.

[2] Includes state and local government expenditures.

[3] Less than 1 percent.

[4] Includes agriculture ($171 million in Puerto Rico).

Source: Puerto Rico figures were prepared by the Governor's Economic Advisory Council. State figures are from the Census Bureau's ***Government Finances in 1986–87.***

PUERTO RICO'S DEBT

Puerto Rico's debt, including that of the Commonwealth, its municipalities, and its public corporations, totaled about $10.1 billion in 1987. On a per-capita basis, Puerto Rico's debt was estimated to be about $2,971 in 1989 and that of state and local governments was $3,175. Puerto Rico's debt is equivalent to 60 percent of its gross product. However, as noted earlier, a comparison with state and local governments' debt is not exact, because some of Puerto Rico's credit activities may be considered similar to some of those of the Federal Government and of private corporations.

Puerto Rico's average annual debt growth rate since 1975 has been fairly constant, ranging from about 5 to 7 percent a year. For state and local governments, it has averaged about 10 percent per year. Puerto Rico's debt for selected years between 1975 and 1987, along with the average annual growth rate, is shown in table 6.5 below.

Table 6.5—PUERTO RICO'S DEBT AND ANNUAL GROWTH RATE (1975–87)

Year	Public debt (In million of dollars)	Average annual growth rate (percent)
1975	$5,089.7	
1978	6,076.5	6.1
1981	7,505.0	7.3
1984	8,692.6	5.0
1987	10,142.6	5.3

Source: Planning Board of Puerto Rico, Economic Report to the Governor of Puerto Rico, 1988.

The proportion of Puerto Rico's debt among the Commonwealth, municipalities, and public corporations has been fairly constant between 1975 and 1987. In 1987, the Commonwealth's portion was 25 percent; the municipalities' portion, 4 percent; and the public corporations' portion, 71 percent. The public corporations' portion peaked in 1981 at 76 percent and has been declining since, while the Commonwealth's portion bottomed out in 1979 and 1991, and has been rising since. The Commonwealth generally uses general obligation bonds, which are guaranteed by the taxing power of the government, while its public corporations use revenue bonds, which pledge the corporations' future revenues for debt repayment.

Puerto Rico's total public debt as a percent of its gross product has declined since 1975. In 1975, it was 71 percent and dropped to 60 percent in 1987. By comparison, state and local government debt as a percent of the U.S. gross national product was 14 percent in 1975, and rose to 16 percent in 1987.

Excluding Puerto Rico's debt attributable to the public corporations, the percent of the Commonwealth's and municipalities' debt in relation to its gross product is comparable with that of state and local governments. Table 6.6 shows Puerto Rico's debt, excluding that of the public corporations, compared with that of state and local governments for selected years between 1975 and 1987. It also compares them as a percent of gross product and on a per-capita basis.

Table 6.6—PERCENT OF DEBT TO GROSS PRODUCT AND DEBT PER CAPITA—PUERTO RICO CONTRASTED WITH STATE AND LOCAL GOVERNMENTS (1975-87)

Year	Puerto Rico			State and local governments		
	Public debt [1] (In millions of dollars)	Debt to gross product (Percent)	Debt per capita	Public debt [2] (In millions of dollars)	Debt to gross national product (Percent)	Debt per capita
1975	$1,433	20	$493	$191,269	12	$886
1978	1,539	17	496	238,032	11	1,069
1981	1,784	15	552	303,767	10	1,320
1984	2,283	16	699	423,757	11	1,788
1987	2,911	17	882	602,795	13	2,471

[1] Does not include debt of public corporations.

[2] Does not include debt of states' utilities.

Source: For Puerto Rico: Planning Board of Puerto Rico, ***Economic Report of the Governor of Puerto Rico: 1988***. For the states: ***Economic Report of the President:*** January 1989, and the Census Bureau's ***Government Finances, 1975–1987.***

[This portion of section 7 has been updated from the 1981 GAO report.]

SECTION 7.—SOCIOECONOMIC CONDITIONS IN PUERTO RICO

The commonwealth of Puerto Rico experienced significant economic growth between 1950 and 1379. It had a 5.2 percent annual growth rate in gross product for these years, after accounting for inflation.[1] Growth declined about 1 percent a year from 1979 to 1983 and recovered to an annual rate of growth of 3.9 percent from 1983 to 1988. While Puerto Rico's economy was transformed during the past four decades from an agricultural to a manufacturing base, some problems, such as relatively low incomes and high unemployment, still persist.

The Commonwealth's economic development strategy promotes manufacturing, which accounted for much of the growth in the island's economy since 1950. In 1988, manufacturing provided 18 percent of total employment and 56 percent of gross product.[2]

There has been a substantial shift in the manufacturing sector from labor to capital intensive industries. For example, textile and apparel employment has remained steady but employment in electrical machinery manufacturing has increased. Since 1980, employment increased the most rapidly in finances (including real estate and insurance) and services (which includes hotels) Federal, Commonwealth, and local governments employed 23 percent of the workforce in 1998, the largest employment sector in Puerto Rico.

Puerto Rico has experienced an improved standard of living since 1950 in areas, such as life expectancy, housing, and education. However, several other 'socioeconomic indicators show less progress. For example, similar to conditions a decade ago, new jobs will need to be created in the future to improve the standard of living and the employment rate. Fifty-one percent of the island's population was under age

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[1] All figures reported for Puerto Rico are based on its July 1–June 30 fiscal year, unless noted otherwise.

[2] However, manufacturing provided 40 percent of gross domestic product in 1988. Gross product includes income earned only by residents of Puerto Rico. Gross product was $18.4 billion in 1988. In contrast, gross domestic product includes all income earned in Puerto Rico, and it was $25.6 billion in 1988.

25 in 1980, compared with a U.S. average of 41 percent. As a result, the future growth in job opportunities will be critical to continuing the improvement in Puerto Rico's standard of living.

PUERTO RICO'S ECONOMY IS TRANSFORMED THROUGH INDUSTRIALIZATION

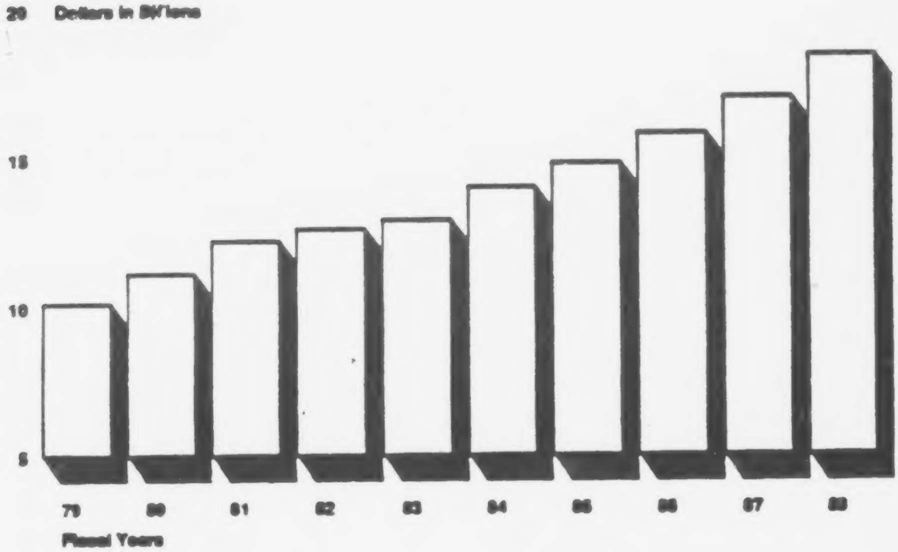
Puerto Rico's economy was based on agriculture until the 1940s. Then the island government recognized that agriculture alone could not sustain its economy and growing population. As a result, it decided to seek economic growth through industrialization. Early attempts to industrialize through government-owned and operated enterprises, however, proved unsuccessful. Puerto Rico's leaders concluded that a substantial infusion of external capital would be required to attain full employment and equalize the standard of living between the states and the island.

Consequently, in 1948 Puerto Rico initiated a program, known as Operation Bootstrap, to attract U.S. manufacturing investment. A comprehensive set of incentives was devised, highlighted by the corporations' total exemption from Puerto Rican corporate income and property taxes. Also, U.S. laws in effect at that time exempted Puerto Rican subsidiaries of. U.S. firms from Federal corporate taxes and allowed duty-free shipments between the states and Puerto Rico.

MAJOR INDICATORS SHOW CONTINUED ECONOMIC EXPANSION

Puerto Rico's economic growth accelerated rapidly after 1950. The island's gross product—the total income available to residents—increased 13-fold between 1950 and 1979. And Puerto Rico's gross product nearly doubled between 1979 and 1988 from $10 billion to over $18 billion as shown in figure 7.1.

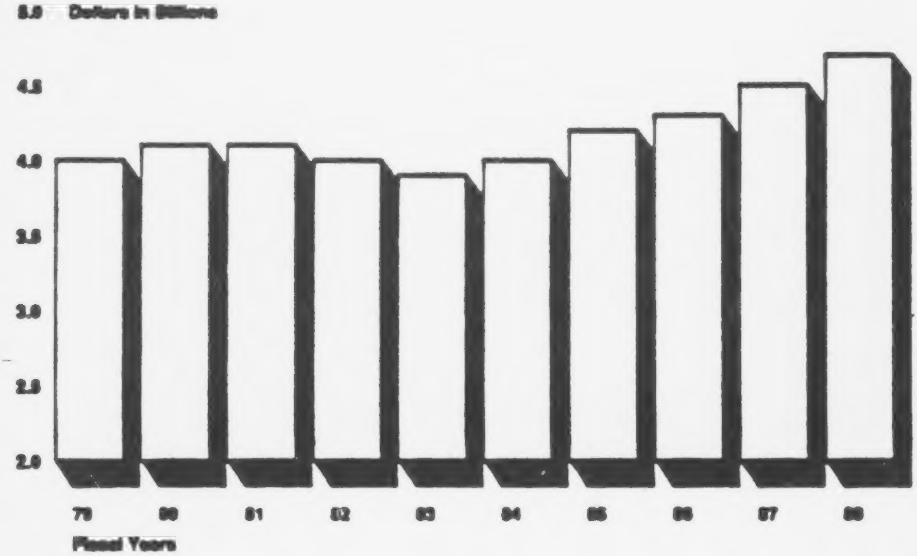
FIGURE 7.1.—PUERTO RICO GROSS PRODUCT (1979-88)



Source: Puerto Rico Planning Board, *Economic Report to the Governor* (1988).

The gross product grew at an annual rate of 5.2 percent a year from 1950 to 1979, after accounting for inflation. As shown in figure 7.2, Puerto Rican real gross product declined from 1979 to 1983 at an annual rate of less than 1 percent and increased from 1983 to 1988 at an annual rate of 3.9 percent. Growth in the U.S. gross national product during these two periods was 1.0 percent and 4.0 percent, respectively.

FIGURE 7.2—PUERTO RICO GROSS PRODUCT (1979–88) (IN CONSTANT 1954 DOLLARS)

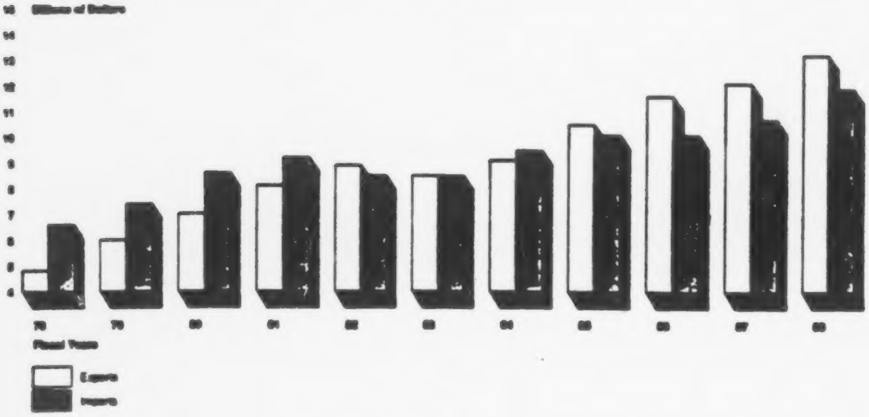


Source: Puerto Rico Planning Board, *Socioeconomic Statistics: 1988.*

As the economy grew, personal income and employment increased considerably. Personal income rose from $653 million in 1950 to nearly $17 billion in 1988. From 1950 to 1988, employment grew from 596,000 to 873,000. Per capita personal income in Puerto Rico grew from $296 in 1950 to $3,149 in 1979, one of the highest in the Caribbean. However, Puerto Rico's per capita income was less than half that of the lowest state at that time. In 1988 its per capita personal income reached $5,157, which was 47 percent of Mississippi's $10,992, the state with the lowest per capita income. Nevertheless, this is an improvement over 1950, when the island's per capita income was 39 percent of that of the lowest state.

Puerto Rico's economic growth was accompanied by substantial trade expansion. Merchandise exports increased from $235 million in 1950 to $13.2 billion in 1988, while imports rose from $345 million to $11.9 billion. Until 1982, imports usually exceeded exports because most raw materials and intermediate goods used by the manufacturing sector were imported as were most consumer goods, including agricultural products. Figure 7.3 shows Puerto Rico experienced a trade surplus in 1982 and annual surpluses beginning in 1985.

FIGURE 7.3—PUERTO RICO TRADE DATA (1978-88)



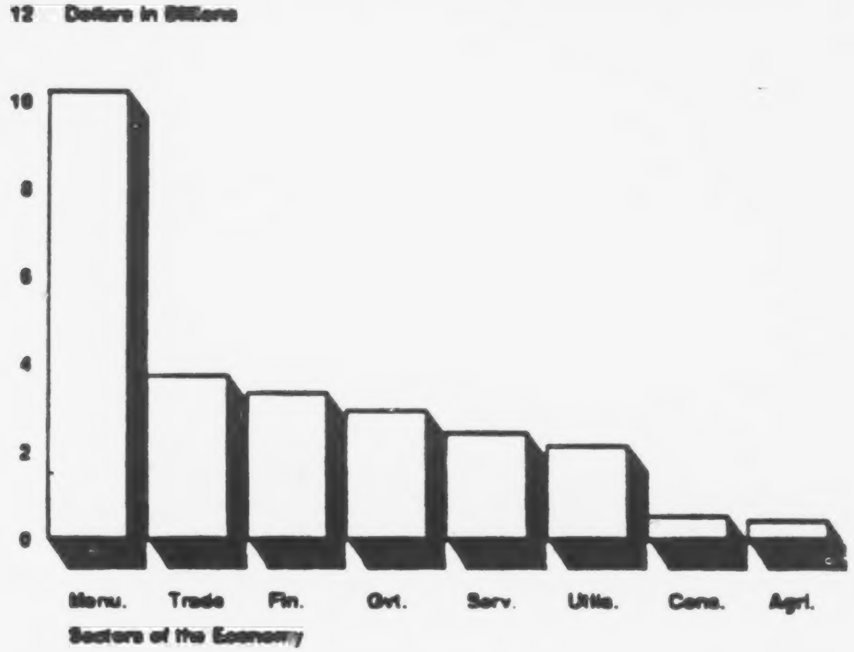
Source: Puerto Rico Planning Board, *Socioeconomic Statistics (1988)*

Puerto Rico's economy is fully integrated with that of the United States. As a result, the states have been its primarytrading partner. The percentage of Puerto Rico's exports to the states has remained relatively constant over the past four decades. It was 89 percent in 1950 and 88 percent in 1988. However, goods shipped from the states have decreased from 92 percent of Puerto Rico's imports in 1950 to 67 percent in 1988.

MANUFACTURING REMAINS THE DRIVING ECONOMIC FORCE BUT ITS STRUCTURE HAS CHANGED

Spurred almost entirely by the investments of U.S. firms, manufacturing has become the most important sector in Puerto Rico's economy. Manufacturing net income increased from $89 million (current dollars) in 1950 to $9.4 billion in 1988, or 62 percent of total net income. Figure 7.4 illustrates the manufacturing sector's role as the dominant contributor to the island's gross product.

FIGURE 7.4—PUERTO RICO GROSS DOMESTIC PRODUCT BY SECTOR (1988)



Source: Puerto Rico Planning Board, *Economic Report to the Governor (1988)*.

From 1950 to 1979, manufacturing jobs grew from 9 to 20 percent of total employment. But between 1980 and 1988 total employment declined to 18 percent, in part because of more rapid growth in other sectors of the economy. In 1988, manufacturing employment stood at about 157,000 jobs. However, there was a shift from labor- to capital-intensive jobs. For example, employment in the apparel industry stayed constant at about 33,600 jobs between 1980 and 1988, while electrical machinery increased from 18,000 to nearly 23,000 jobs during the same period as shown in table 7.1.

Table 7.1—DISTRIBUTION OF EMPLOYMENT IN PUERTO RICAN MANUFACTURING INDUSTRIES (1980-83)

Industry group	Employment in thousands		Absolute change	Percentage change
	1980	1988		
Electrical equipment	18.0	22.8	4.8	26.7
Chemicals	15.6	19.1	3.5	22.4
Paper and allied products, printing and publishing	5.1	5.4	3	5.9
Textile mill products	3.4	3.6	2	5.9
Scientific instruments	13.6	13.8	2	1.5
Food and kindred products	23.4	23.6	2	9
Apparel	33.5	33.6	0.0	0.0
Wood and furniture products	3.6	3.5	-1	-2.8
Stone, clay and glass items	4.8	4.6	-2	-4.2
Petroleum, and allied products	7.7	7.2	-5	-6.5
Primary metal and allied products	5.3	4.9	-4	-7.5
Leather and leather products	6.6	5.9	-7	-10.6
Miscellaneous	3.9	3.1	-8	-20.5
Non-electrical machinery and transportation equipment	7.9	4.7	-3.2	-40.5
Tobacco products	2.1	1.2	-9	-42.9

Table 7.1—DISTRIBUTION OF EMPLOYMENT IN PUERTO RICAN MANUFACTURING INDUSTRIES (1980-83)—Continued

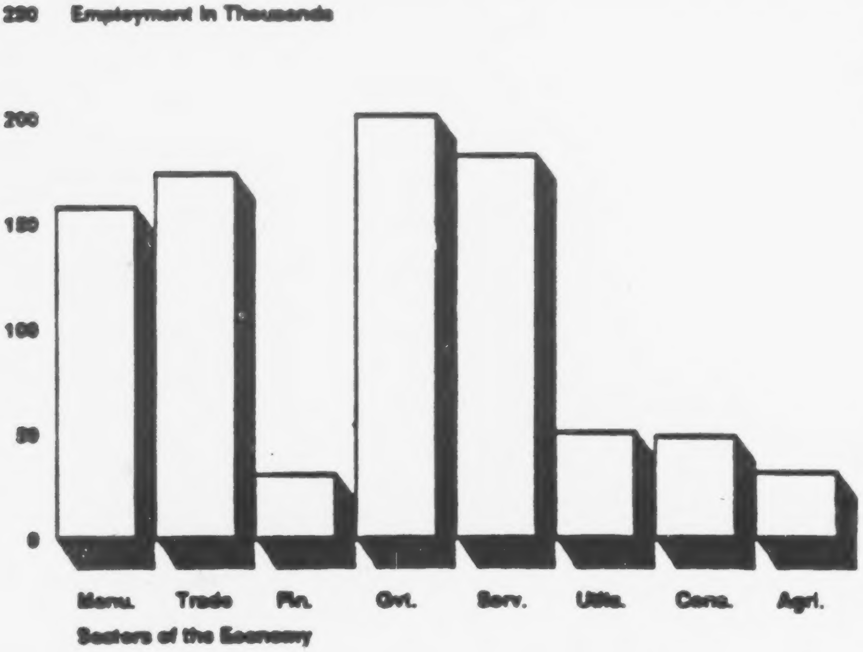
Industry group	Employment in thousands		Absolute change	Percentage change
	1980	1988		
Total	154.6	157.0	2.4	1.6

Sources: Commonwealth of Puerto Rico, Department of Labor and Human Resources, ***Census of manufacturing Industries of Puerto Rico, 1980 and 1988.***

GOVERNMENT REMAINS A MAJOR SECTOR OF THE ECONOMY

While manufacturing is the largest contributor to Puerto Rico's gross product, government has become the leading sector in terns of employment as shown in figure 7.5. By 1988, the government employed 201,000 people at all levels—Federal, commonwealth, and municipal which comprised 23 percent of the total workforce. In addition, spending of the federal, commonwealth, and municipal governments contributed 24.1 percent of the island's gross domestic product in 1988.

FIGURE 7.5—EMPLOYMENT IN PUERTO RICO BY ECONOMIC SECTOR (FISCAL YEAR 1988)



Source: Puerto Rico Planning Board, *Economic Report to the Governor (1988).*

Federal disbursements to Puerto Rico increased from $2.9 billion in 1979 to $4.2 billion in 1988. Transfer payments to individuals, such as earned pensions and welfare, and social security entitlements, comprised 21.4 percent of Puerto Rico's personal income in 1988 (it was 21.2 percent in 1979). In the states, transfers to individuals were about 13.7 percent of personal income in 1988.

Federal income support expenditures in Puerto Rico include earned benefits, for veterans such as pensions, medical services, and related support. For example, about 68,000 veterans of the conflicts in Korea and Vietnam were residing in Puerto Rico in March, 1988. The Department of Veterans Affairs had fiscal year 1988 spending in Puerto Rico of $394.8 million. Compensation and pension payments to veterans represent about 57.3 percent of that figure.

Puerto Rico's central and municipal government employment has grown at roughly the same rate as the Puerto Rican economy but economic expansion has outpaced growth in public expenditures. From 1979 to 1988, government employment increased at an average annual rate of 1.8 percent compared with 1.9 percent for the overall Puerto Rican economy and 0.8 percent for the manufacturing sector. By 1988, all government sector employment was 201,000 persons or 23 percent of the total workforce. But, government operating expenditures from the general fund, excluding the public corporations, grew from $2.0 billion in 1979 to about $3.0 billion in 1988 or about 5 percent per year, while its share of the island gross product decreased from 17 percent in 1979 to 15.8 percent in 1988.[3]

The Commonwealth provides many public services that are typically local government functions in the states, including public education and police and fire services. In addition, the Commonwealth provides public utility services and owns proprietary-type companies which are typically private sector functions in the states. These include public ownership and operation of the Puerto Rico Telephone Company, Electric Company, Sugar Corporation, and a maritime freight shipping company.

OTHER ECONOMIC SECTORS ALSO GREW SUBSTANTIALLY

In addition to manufacturing and government, other economic sectors achieved substantial growth. As shown in table 7.2, net income and employment between 1980 and 1988 increased markedly in services (including hotels) and finances (including insurance and real estate).

Table 7.2—INCREASE IN NUMBERS OF PERSONS EMPLOYED AND INCOME IN SELECTED PUERTO RICAN ECONOMIC SECTORS (1980–88)

	Employment			Net income		
	1980 (In thousands)	1988 (In thousands)	Increase (percent)	1980 (In millions)	1988 (In millions)	Increase (percent)
Finance, insurance, and real estate	21	30	43	$1,346	$2,806	108
Manufacturing	143	157	10	4,809	9,433	96
Services (including hotels)	135	182	35	1,130	2,074	94
Transportation and other public utilities	47	50	6	1,003	1,634	63
Trade (wholesale and retail)	138	173	25	1,621	2,590	60
Construction	44	48	9	339	447	32

Source: Puerto Rico Planning Board, *Economic Report to the Governor (1988)*.

The hotel industry, which is an essential component of the tourism sector, experienced serious financial problems during the 1970s. In 1977, for example, the net consolidated loss for hotels was $6.6 million. There had been rapid construction in the 1960s, and the number of hotel rooms peaked at 9,806 in 1975. The number of rooms decreased about 37 percent from 1975 to 1989. Despite the decline in hotel rooms, the number of hotel visitors increased 10.2 percent from 1975 to 1988. The increase in the number of hotel registrations coupled with a decline in hotel rooms has increased the percent of rooms rented from 58.8 in 1383 to 74.5 in 1998.

GAINS IN SOCIAL CONDITIONS REALIZED, BUT PROBLEMS REMAIN

The island's economic growth was accompanied by significant improvements in social conditions. Despite gains in the adequacy of health care, housing, and education, however, problems remain.

Better medical and sanitation services, among other factors, contributed greatly to controlling infectious diseases and reducing infant mortality rates in Puerto Rico. As a result, the island's life expectancy was 74 years in 1986, slightly higher than the U.S. average and one of the highest in the world.

The island's housing stock and quality also increased greatly. While in 1940, 80 percent of Puerto Rico's housing was considered inadequate, this number was reduced to 18.2 percent by 1980, according to the latest U.S. Census of Housing. Various factors, including island land reform and Federal assistance and mortgage insurance, have continued to contribute to improved housing. However, in 1980, 12.4 percent of occupied housing in Puerto Rico lacked complete private plumbing facilities compared with 2.2 percent in the United States.

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[3] About $679 million of this is Federal grants-in-aid. If this is excluded, the Commonwealth's share of gross domestic product would be about 9.7 percent.

Educational opportunities also have improved markedly. While only one-half of the eligible children attended school in 1940, four of five were enrolled in 1976, and significant progress has been made in reducing illiteracy, which was 80 percent at the turn of the century. While the population is predominantly Spanish-speaking, about 42 percent has some English proficiency, according to the 1980 census. Despite this educational progress, severe problems exist. The island's illiteracy rate was about 11 percent in 1988. In the United States as a whole, the illiteracy rate has been estimated at 1 percent. Furthermore, elementary and secondary educational expenditures are estimated at nearly $1,400 per pupil in fiscal year 1988 in Puerto Rico. In fiscal year 1985, the lowest state expenditure was $1,594 per pupil. Nevertheless, higher education is increasingly in demand in Puerto Rico. From 1970 to 1987, the percentage of persons aged 18-24 attending college more than doubled from 17 percent to 40 percent. While 48 percent of the 18-24 population attended college in the United States, the rate of increase has been much faster in Puerto Rico. Enrollment in public and private colleges totalled about 155,800 in 1988.

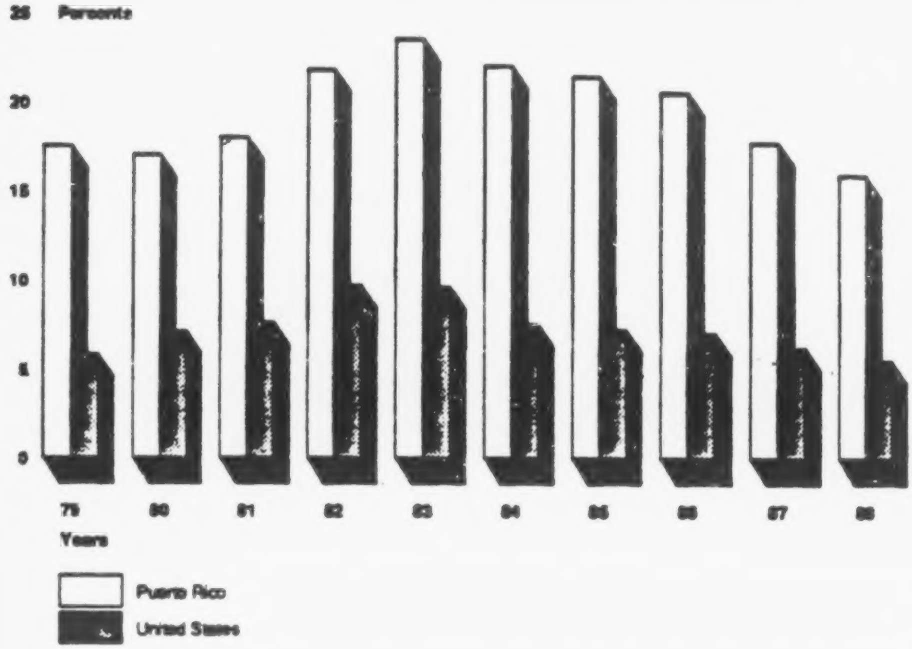
Despite progress on a number of fronts, Puerto Rico faces various urban ills such as crime, alcoholism, drug addiction, and mental health problems. And crime is a problem in Puerto Rico. According to the Federal Bureau of Investigation, 46 states (including the District of Columbia) had higher crime rates than Puerto Rico. Puerto Rico's crime rate was 3,358.8 per 100,000 population in 1987 compared with 5,550 per 100,000 in the United States. However in terms of violent crime, only 7 states had a higher violent crime rate than Puerto Rico. Also, the island's 1985 infant mortality rate was 14.9 per thousand live births compared with 10.6 per thousand in the United States. Only the District of Columbia had a higher infant mortality rate in 1985.

CHRONIC POVERTY AND UNEMPLOYMENT PERSIST

Chronic high poverty rates persist in Puerto Rico despite an improving economy. In 1979, the Census Bureau reported 62.4 percent of Puerto Rico's population had incomes below the Federal poverty level, compared with 12.4 percent of the U.S. population.

Although total employment in Puerto Rico grew frown 1950 to 1979 population growth exceeded job creation by more than 15 percent. From 1978 to 1988, the reverse has been true as job creation has increased at a rate nearly three times that of population growth. But island unemployment continues to be two to three times greater than the national average and incomes remain relatively low. In calendar year 1988, the unemployment rate was 15.0 percent compared with the U.S. average of 5.5 percent (Louisiana had the highest unemployment rate, 10.9 percent in 1988) This has been partially responsible for the high levels of participation in public assistance programs. For example, in 1988, 43.5 percent of the population was eligible for the Nutrition Assistance program, a more restrictive version of Food Stamps, which operates only in Puerto Rico. Finding employment for an expanding population has been a problem in Puerto Rico. As shown in figure 7.6, unemployment was about 17.5 percent in fiscal year 1979 and increased to 23.5 percent in 1983 before declining to 15.9 percent in 1988.

FIGURE 7.6—PUERTO RICO AND U.S. UNEMPLOYMENT RATES (1979-88)



Source: Puerto Rico Planning Board, *Preliminary Report of the Economy of Puerto Rico* (1988); Department of Labor, Bureau of Labor Statistics, *Employment and Earnings* (May 1989).

The island's industrialization created a net increase of 102,000 manufacturing jobs from 1950 to 1988 along with 19,000 jobs in other nongovernment sectors. During the same period, however, the agricultural sector lost 179,000 jobs while 50,000 home needlework jobs also were eliminated between 1950 and 1979.

Moreover, because the manufacturing sector became increasingly capital intensive, the island's industrialization did not absorb the labor force growth from 1950 to 1979.

Two factors, however, have served to stabilize employment and population trends in Puerto Rico—government employment and out-migration. Government employment (Federal, commonwealth, and municipal) increased from 106,000 in 1970 to 201,000 in 1988, an increase of 89.6 percent. Additionally, migration to the states totaled about 700,000 persons from 1947 to 1972. Net outmigration is estimated at 280,000 from 1980 to 1988. About 2.3 million Puerto Ricans now reside in the states.

Puerto Rico's population has grown from 2.9 million in 1975, to 3.3 million in 1988 according to the *Economic Report to the Governor (1988)*. Puerto Rico's population density was 947 persons per square mile in 1986; this is 14 times greater than that of the United States as a whole and comparable with Rhode Island, which has a population density of 924 persons per square mile.

Average family size has been declining in Puerto Rico. Average family size was 5.2 persons in 1940 and declined to 3.7 persons in 1979. From 1980 to 1988, Puerto Rico had a population increase of nearly 3.6 percent, compared with 8.1 percent in the United States.

Moreover, the island's population has become predominately urban. In 1980, 67 percent of the population was classified as urban, compared with 30 percent in 1940 (in 1980, 74 percent of the U.S. population was classified as urban) As of 1980, about one-third of the island's population lived in the San Juan metropolitan area. Further, 51 percent of Puerto Rico's population was under 25 years of age in 1980 whereas it was 41 percent under age 25 in the states. But the Puerto Rico Planning Board estimated that the percentage of the population under age 25 will decline to

41 percent by the year 2000. Having an increasingly older population may somewhat reduce the pressure for new job creation.

[This portion of Section 7 has been reprinted from the 1981 GAO report. It has not been updated.]

PROGRAMS TO DIVERSIFY AND STRENGTHEN ECONOMY AND REDUCE UNEMPLOYMENT ARE BEING PURSUED

Because Puerto Rico possesses few exploitable natural resources to sustain economic growth, the island's economy is characterized by extensive trade, primarily with the United States. Many mainland-based manufacturing corporations, which provide most of the island's capital investment, import most of their raw materials and, because local markets are too small, export most finished products to the United States. This situation, combined with the fact that a substantial portion of Puerto Rico's population obtains income support from U.S. transfer payments, makes the island's economy very sensitive to mainland decisions and economic conditions.

Manufacturing will continue to be the stanchion of Puerto Rico's economy, but island government officials believe that more selective promotion of manufacturing is needed and that the economy needs to be more balanced and diversified. Noting that no one sector should dominate the economy to the degree manufacturing does today, these officials believe that other sectors also should be promoted.

One notable program initiated by the Commonwealth government involves modernizing and revitalizing agriculture to reduce dependence on imported foodstuffs and provide employment. With the advent of Puerto Rico's industrialization, the amount of land and attention devoted to agriculture was decreased. By 1979 agriculture accounted for less than 5 percent of island employment. Production of the traditional cash crops—sugar, coffee, and tobacco—had declined and become unprofitable by 1979. Although production of other items like livestock and dairy products increased, the island still imported over $1 billion in foodstuffs annually in 1979.

A 1978 Commonwealth report stated that island agriculture was based generally on outdated technology and inefficient production. As a result, Puerto Rico devised a 12-year plan to modernize the agricultural sector. If successful, the program would establish a rice industry, enable Puerto Rico to grow many agricultural products currently imported, and create about 10,000 additional jobs by 1988. Agricultural employment actually declined by about 5,000 from 1978 to 1988.

In 1979, the U.S. Department of Commerce concluded that because the recent pace of government hiring cannot be maintained, employment in agriculture, manufacturing, and non government service industries such as tourism must grow if Puerto Rico's unemployment is to be reduced materially. In 1978, the island government extended tax exemptions to service industries to further promote this industry. As of June 1980, nine such exemption grants had been approved, but officials believed it was too early to assess the overall effectiveness of the program.

Several other areas also are being considered to help diversify the economy. For example, although copper and nickel deposits exist, their quality has not justified commercial mining. The recent rise in market prices for these metals, as well as for the gold and silver by-products obtained in their development, may make these deposits exploitable in the future.

Investigations also have suggested the possibility that oil deposits exist in Puerto Rico. The Commonwealth government plans a $5 to $6 million sampling program at one promising onshore area to determine whether actual drilling for oil is justified. The government is planning to negotiate with private companies to attempt the far more expensive challenge of offshore drilling. Further exploration and testing are needed to indicate whether oil deposits exist and, if so, whether they are commercially retrievable.

Diversification of export destinations also has been cited as a means for opening up new markets for Puerto Rican products and generating additional employment. To enhance this effort Puerto Rico has begun trade missions to other countries and seminars have been sponsored to inform local businessmen about exporting their products.

Another potential employment producing strategy would be to replace certain imports with locally produced goods. Puerto Rico's Economic Development Administration estimated that import substitution could create thousands of jobs. The Economic Study of Puerto Rico was less positive in its assessment but suggested that some potential for such a program existed.

[This section is reprinted from the 1981 GAO report. It has not been updated.]

SECTION 8.—THE STATUS OPTIONS: SIMILAR CONCERNS, BUT IDEOLOGICAL DIFFERENCES UNDERSCORE DEBATE

Although amended commonwealth, statehood, and independence proposals have been made, the Puerto Rican people have not voted on the status issue directly since 1967. The general election results since 1952 are shown in table 8.1, but these do not necessarily reflect support for each status since other issues, such as economic conditions, were involved in the campaigns.

Table 8.1—GENERAL ELECTION RESULTS SINCE 1952

[In percent]

	Party(ies) favoring Commonwealth	Party(ies) favoring statehood	Party(ies) favoring independence
1952	64.8	12.9	19.0
1956	62.5	25.0	12.0
1960	62.4	34.3	3.3
1964	59.4	34.6	2.7
1968	51.8	45.2	3.0
1972	51.0	45.5	4.5
1976	45.3	48.3	6.4
1980	47.0	47.2	5.7

Puerto Rico's local political parties are aligned according to status preferences—an historic consequence of the continuing debate. Traditionally, various parties have advocated the concepts of commonwealth, statehood, or independence. Presently, one party supports statehood, another favors improving Commonwealth status, and two parties advocate independence.

The Popular Democratic Party (PDP) supports an improved commonwealth. The PDP dominated island politics from 1940 to 1968, when it lost the governorship to statehood supporters. The PDP regained power in 1972, but lost again in 1976.

The New Progressive Party (NPP) advocates admission to the Union. The party was formed from earlier statehood parties in 1968, and later that year NPP's gubernatorial candidate was elected. It lost in 1972, regained the governor's seat in 1976, and retained it in 1980.

The two parties supporting independence are the Puerto Rican Independence Party (PIP) and the Puerto Rican Socialist Party (PSP). Formed in the mid-1940s, the PIP is dedicated to independence and democratic socialism. The PSP, committed to independence and socialism, first participated in local elections in 1976.

PUERTO RICO'S STATUS DILEMMA: CHOOSING FROM DIVERGENT ALTERNATIVES

Heightening awareness of Puerto Rico's status controversy has kindled increased interest in the various status options. Each is advocated and defended with intensity and emotion and is based upon a diverse philosophy. Moreover, each position has been shaped by Puerto Rico's social and economic environment. However, despite sharp differences, statehood, commonwealth, and independence advocates, albeit in varying degrees, have expressed some similar basic concerts.

Intensely proud of their Puerto Rican heritage, all status participants are adamant about preserving the island's language and culture. Further, all maintain that Puerto Rico has not attained a full measure of dignity and a solidified identity. Each argues that the current status is one of political and personal inferiority and does not meet the needs of the Puerto Rican people.

The desire for equality and increased political rights comprises the nucleus of each status option, but concerns over the island's serious social and economic problems also transcend partisan lines. Participants recognize that a new status will not automatically solve all the island's difficulties; however, participants assert that an alternative legal, constitutional framework is required to guide Puerto Rico's socioeconomic advancement.

Aside from these few points, however, status participants are divided sharply—both on an ideological basis as well as a political one. This intense and longstanding divisiveness has been cited as a major factor undermining Puerto Rico's ability to effectively combat its social and economic difficulties. After extensive hearings and discussions, the 1966 U.S.-Puerto Rico status commission report astutely concluded that:

> Status choices, the Commission has come to see, are in a sense political 'subcultures' within Puerto Rico's society. Each status viewpoint holds an interpretation of history, a way of life, a concept of the Puerto Rican identity, and an aspiration for a Puerto Rican destiny. Ideological differences alone make consensus difficult, but that difficulty is nurtured by the partisan political character of the status parties and by electoral competition. Thus, political opposition and ideology regularly enforce one another to intensify the conflict over status.

Since then, this historic dilemma has been accentuated by economic and financial difficulties and increased criticism of the present Commonwealth's ability to meet Puerto Rico's needs—politically or economically. Because each major political party has proposed status alternatives, the following sections summarize each option's basic political rationale as a preface to our analysis provided below.

These synopses, based on the parties' platforms and other material, contain views on why each party believes its status is the most logical. Not included are each party's assertions about why the other two options are unfeasible. Also not detailed here are the parties' beliefs about their proposals' numerous financial, social, economic, and other benefits; however, these views are discussed in sections 5 through 7 on a topical basis.

Statehood Advocates Desire Equality Within The American System

Since Puerto Rico became part of the United States, statehood has been a goal of certain local political parties. Advocates believe that only statehood would bring Puerto Ricans political and economic equality, dignity, and security. Maintaining that statehood is the inevitable culmination of the island's political development, proponents advocate that admission would eliminate the current status' inadequacies and foster the island's development.

Statehood advocates maintain that the present relationship is one of inequality and inferiority—one that retains "vestiges of colonialism" and relegates Puerto Ricans to second class citizens. Proponents state that although Puerto Ricans are U.S. citizens, they cannot participate fully in the American political system. Governor Carlos Romero-Barcelo, a staunch statehood advocate, explains that:

> If Puerto Rico were a state, we would have seven representatives in the House, two United State senators, and nine electoral votes for President—more electoral votes than twenty-five of the existing states. But without statehood, we lack the political rights that make citizenship in a democracy truly meaningful.

Advocates assert that the island is still a territory, subject to the Congress' broad authority. As such, they state that the Congress can treat the island differently from states by excluding or restricting its participation in certain Federal activities. Moreover, they point to a recent U.S. Supreme Court case upholding such differential treatment and a "long history of discrimination and unfair treatment against the residents of Puerto Rico in fundamental Federal legislation, grants-in-aid, and other programs."

Another inequality statehood advocates cite is that Puerto Ricans have paid their "blood tax" through military participation since World War I, but island residents cannot vote for or against the Commander-in-Chief.

Advocates maintain that statehood is the key to eliminating such inequality and increasing the island's participation in shaping America. They also believe there is little known about Puerto Rico on the U.S. mainland. Governor Romero notes that "We are still looked upon as outsiders—and sometimes even as foreigners—by our fellow American citizens in the rest of the nation."

Although recognizing this problem, supporters view the granting of U.S. citizenship in 1917 as a vital factor in sustaining the statehood movement. The identify citizenship as the indissolvable link between the Island and the states and maintain that statehood would bring fulfillment of the implied admission promise inherent in citizenship.

Advocates emphasize that Puerto Ricans have continually demonstrated their loyalty to American democratic principles and the private enterprise system. They point to the island's adoption of many American doctrines, traditions, and institutions and of a constitution patterned after the Federal model. They cite residents' substantial contributions to defending the nation through military service for many years. Additionally, advocates point to the extensive trade between the island and the states and the integration of their economies.

Proponents state that Puerto Rico has made substantial socioeconomic progress but argue that statehood is needed to resolve the island's problems. They believe statehood would provide the necessary legal instrument for assuring political equality, social justice, and economic security, as well as enhancing the island's prosperity and role in national matters. Governor Romero summarizes this sentiment as follows:

> I am convinced, both as a Latin American and as a U.S. citizen, that statehood for Puerto Rico would constitute a boon for the nation, as well as for the island . . . . We statehooders are therefore committed to forging a society in which, while remaining faithful to our linguistic and cultural traditions, we can make a full and meaningful contribution to building a better America, in exchange for full and meaningful participation in the process by which America is governed.

Advocates maintain that statehood will reduce, rather than increase, Puerto Rico's reliance on Federal transfer payments. They believe admission would create more natural economic growth and stimulate investment in such areas as manufacturing, agriculture, and tourism by providing political security, increasing awareness of Puerto Rico, and enabling the island to better use its abundant labor supply.

Further, statehood would assure the island equal treatment in Federal programs and laws as well as full representation in the U.S. Congress. Advocates believe that equal political representation would give Puerto Rico a stronger voice in federal legislation, strengthen Federal awareness of the island's problems, and greatly enhance Puerto Rico's ability to increase its share of Federal investments to help stimulate the economy.

Statehood advocates recognize that although admission would bring political equality It will also entail significant fiscal adjustments; but they propose this process be phased in gradually over several years. Proponents express their desire to pay Federal taxes to correct the current one-sidedness and give residents a greater sense of dignity and self-worth by contributing to common goals. They note, however, that the longstanding absence of Federal taxation puts the island in an unprecedented situation.

Supporters point out that new states have traditionally been granted a wide range of concessions and that the Congress has the broad authority to accommodate the island's special needs. Advocates argue that Puerto Rico's situation presents unique circumstances dictating a commensurate approach in devising adequate admission arrangements. Such terms should, they maintain, preserve the island's language and culture and provide for phasing in full Federal taxation. This proposal and other examples of transitional arrangements advocates believe are indicative of the type needed are discussed further in subsequent sections.

While recognizing that fiscal adjustments are necessary, statehood supporters assert that admission cannot be viewed solely in financial terms. They declare that the fundamental issue is their full and equal rights as citizens within a democracy and the quest for dignity. This goal, Governor Romero proclaims, "is political equality within a framework which will permit our island and our nation to prosper together."

Commonwealth Proponents Want To Keep Ties But Seek Greater Autonomy

Traditionally, supporters of the commonwealth concept have espoused predominantly autonomist principles. Essentially, this translates into strong ties with another country—Spain and later the United States—while developing greater self-government for Puerto Rico within this broader political system. Support for these principles resulted in the island's 1897 Charter of Autonomy with Spain and fostered the present Commonwealth relationship.

In every decade since 1952 Commonwealth proponents have advocated revisions to clarify that status and expand the island's political powers. Supporters maintain that Commonwealth is a legitimate status in and/of itself. They argue that the present fundamental relationship between Puerto Rico and the United States should be continued, but changes are necessary to give Puerto Rico greater flexibility and to assure the viability of the commonwealth principle.

The most recent description of the rationale for greater autonomy has been Governor Raphael Hernandez-Colon's "New Thesis," introduced on July 25, 1979. An aide to the Governor stressed that the New Thesis outlines why greater autonomy is needed and identifies general areas where change is required, but he stated that changes to the present status are potentially exhaustive and that exact methods need to be studied and worked out in greater detail later.

The Popular Democratic Party endorsed the New Thesis' general principles in its 1980 electoral platform. The New Thesis maintains that Commonwealth status has served Puerto Rico well but needs amending so the island can deal effectively with pressing social and economic concerns. Basic U.S.-Puerto Rico ties are to be preserved, but greater political autonomy is believed necessary to enhance self-sufficiency and resolve the current confusion and lack of orientation.

Mr. Hernandez-Colon maintains that the principal advantage of the autonomous system is its flexibility to accommodate the island's aspirations and particular needs within its tie to the United States, but outside the latter's rigid internal structure. He argues that despite the 81-year relationship with the United States, the island has retained its unique cultural and linguistic features—the foundation of Puerto Rico's identity and autonomy.

The New Thesis asserts that this autonomy needs to be increased over internal matters and expanded to include authority to make arrangements with other countries. It states, however, that equally as important is preserving political, social, cultural, economic, and emotional bonds between Puerto Rico and the United States, which have profoundly affected the island's development.

These ties, particularly common citizenship, must be maintained while preserving Puerto Rico's autonomist identity, argues Mr. Hernandez-Colon. He states further that when citizenship was extended it was anticipated that the island would have an autonomous political system. He notes that common citizenship is deeply honored and its privileges defended by Puerto Ricans through military service, but island residents' identity comes from being Puerto Rican, not from being U.S. citizens:

> Our Puerto Rican nationality has been given U.S. citizenship, which adds to it a special dimension of protection and political loyalty for coexistence, but not to compete with or reduce the basic and deep loyalty that for vital reasons ties us to the motherland.[1]

The New Thesis asserts that citizenship should not be viewed as a step to statehood but rather as a source of rights so that Puerto Ricans can affirm themselves as individuals while retaining their unique characteristics. This citizenship, Mr. Hernandez-Colon maintains, along with Puerto Rico's right to freely pursue self-determination, strengthens the island's position to decide its future. He argues that commonwealth status has resulted in great socioeconomic achievements but that widespread dissatisfaction and critical social and economic problems dictate a reevaluation of the present arrangement.

The New Thesis presents proposed strategies to handle the island's problems but maintains that they cannot be effectively resolved without greater autonomy. Mr. Hernandez-Colon asserts that to spur economic investments and begin educational reform greater flexibility is needed. He proposes that Federal assistance to the Puerto Rican government be allocated in a block grant rather than on a program basis. Also, he states that control over communications (radio and television) is needed for educational purposes.

Further, Mr. Hernandez-Colon maintains that Puerto Rico needs to develop a human resource policy for generating employment opportunities; reduce its dependence on the Federal Government and foreign capital; remold the island's manufacturing and agricultural sectors to better use foreign investment; and institute social and educational reforms. To make any strategy work, however, he states that the island needs to be granted authority over immigration of foreigners, everything related to labor relations (wages and work conditions) 1 use of natural resources and the sea, environmental regulations, entry of foreign products through tariff controls, and negotiations with foreign countries.

Mr. Hernandez-Colon argues that many of these necessary adjustments to the commonwealth formula were ignored when the proposed 1975 Compact of Permanent Union was not acted upon. Consequently, he states that the status issue should be pursued vigorously to effect the appropriate revisions. Similarly, in its 1980 platform the Popular Democratic Party emphasized its pledge to pursue expanding the Commonwealth's authority.

The New Thesis maintains that the Commonwealth concept should be a dynamic process that can be modified as circumstances change. Mr. Hernandez-Colon asserts that contemporary Federal and international realities make adjustments necessary. He states that because of growing internal requirements, Puerto Rico needs to increase its local authority and widen its external relations in search of resources and agreements that will suit its economic and cultural needs. This situation, Mr. Hernandez-Colon argues, mandates that Puerto Rico be granted greater autonomy.

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[1] Quotation taken from English translation of the New Thesis.

Independence Supporters Advocate Complete Autonomy

Independence has been an aspiration of certain Puerto Rican groups since Spanish dominion. In fact, a brief revolt against Spain in 1868, known as the Gritode Lares, became a symbol for independence supporters. The independence option has continued to be advocated during the association with the United States. Presently, two political parties certified to participate in local elections espouse independence as their status goals—the Puerto Rican Independence Party (PIP) and the Puerto Rican Socialist Party (PSP)

The PIP, steadfastly committed to independence and democratic socialism, states that complete autonomy is required to correct the heart of Puerto Rico's very serious social and economic problems. It asserts that the colonial relationship with the United States has precluded the island from possessing the necessary political and economic authority to, among other things:

—protect and adequately develop its cultural and national identity;
—safeguard industry, agriculture, and trade; correct unemployment by establishing a rational program for replacing imports; diversify foreign trade; and regulate immigration; and
—control the monetary system, prevent the flight of financial resources abroad, and develop a wage and price policy.

The PIP regards the current situation as an intense social and economic crisis. Numerous social ills, including rising crime, poverty, drug addiction, and mental health problems, the PIP states, have their roots in the colonial capitalist structure which raises aspirations far beyond Puerto Rican reality. Additionally, it asserts that this has resulted in a state of dependence, powerlessness, and a lack of self-worth. The PIP maintains that:

> This is so because from the time our children are small they are taught in our schools that 'Puerto Rico is a small and poor country without mineral resources,' and that "we have two flags, two anthems, two languages and two cultures." It is repeated to the point of satiation that the Commonwealth is not a colony, that this status is "our creation, what serves us, what we breathe and what gives us life," [2]

This, the PIP asserts, is why Puerto Rico has an identity crisis and its people are terribly insecure over what might happen.

The PIP also emphasizes that the pattern of dependence extends to economic problems as well. It states that economic stagnation, chronic unemployment, and inflationary trends have occurred because Puerto Rican growth was created through a colonial system. This dependent model, it explains, is characterized by reliance on foreign capital, exportation of production and importation for consumption, excess consumption financed through debt, and emphasis on economic growth, rather than real development based on a fairer distribution of wealth.

The PIP platform details an alternative socioeconomic development model and outlines proposals to solve specific difficulties and to form the basis for resolving the problems of colonialism and dependent capitalism. It asserts that dependence on external capital, welfare payments, and foreign debt will continue unless the transition to independence is initiated.

The PIP recognizes that this conversion would be a difficult process requiring a transitional period. It explains that as a colony almost every vital aspect of Puerto Rican life has been controlled by the United States. This integration and domination, the PIP maintains, has created a situation where independence can be adequately achieved only through an "orderly, rational and responsible transition."

While acknowledging that this process should benefit both countries, the PIP asserts that the transition should eliminate the colonial distortions which have made the island's economy dependent on U.S. needs. Accordingly, the party has developed several transition proposals, which are discussed in the following sections. The PIP has emphasized, however, that there is no limit, constitutionally or otherwise, to the kinds of arrangements that could be established between an independent Puerto Rican republic and the United States.

Although it recognizes that a transition would be difficult, the PIP maintains that independence would bring more permanent and self-reliant economic growth. This would be based on increased production and employment, a fair distribution of wealth, Puerto Rican control of its economy, reduced foreign dependency, and a social policy and political ethic to raise the island's standard of living.

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[2] Quotation taken from English translation of PIP 1980 electoral platform.

The President of the PIP, Mr. Ruben Berrios Martinez, maintains that independence is the only solution for Puerto Rico and would be best for the United States:

> The Republic of Puerto Rico, conceived in liberty and founded on rational and equitable' economic principles, would protect the interests and rights of the people of Puerto Rico; free the American taxpayer of the increased cost of maintaining an unworkable economic system; and would make U.S. policies conform to the principles of liberty on which the Union was founded as well as the principles of contemporary international law.

Advocates believe that obtaining complete political autonomy will more than offset the current arrangements with the Federal government. More importantly, however, they argue independence is the inalienable right of the Puerto Rican people and would bring dignity and full control over the island's economic, social, and cultural development.

The Puerto Rican Socialist Party (PSP), committed to socialism and the rights of workers, firmly supports independence as the solution to the island's status dilemma. The PSP states that it will never renounce this goal regardless "of the adverse changes that may come about in the status of the country." The party advocates eliminating the capitalist system and imperialism which it believes underlies many of the island's present political, social, and economic problems.

The PSP believes that the island's political electoral process is invalid, stating that:

> The constrained limits of that process, determined by the framework of our relationship of colonial subordination to the United States, makes it impossible for there to even be a valid electoral process under the standards of bourgeois democracy.[3]

Although the PSP has participated recently in elections, it does so under the basis of maintaining its independence and "impugning, not recognizing, the validity of the colonial administration and its institutions."

The party notes other examples of colonial domination, such as the U.S. Navy occupying and using the island, Vieques, deforming Puerto Rico's national culture through the educational system, and rising crime because Puerto Rico cannot control the immigration of undesirables from the U.S. mainland. Other examples cited are deteriorating family life because of capitalist developments and alienation and persecution found in all sectors of the country. This situation, the PSP states, has occurred because Puerto Rico does not possess the legal means to solve problems facing its society.

The PSP further cites the precarious nature of the present economic structure, which is characterized by high unemployment, low income levels, high debt, and declining levels of investment. The party believes this model to have failed because so many people are impoverished while foreign capital obtains billions in profits. It points out that the only factor preventing total collapse has been the influx of substantial Federal aid.

The PSP advocates a number of social and economic solutions to increase workers' rights, combat crime, improve health care and education, and stimulate agriculture. The party points out, however, that many remedies cannot be implemented because Puerto Rico is not independent. For example, the island does not have authority to regulate immigration; impose tariffs to protect local production, particularly agriculture; and control all natural resources.

Although the PSP advocates independence, it maintains that any valid status decision can be made only after the United States totally and unconditionally transfers all powers to Puerto Rico. Mr. Juan Mari-Bras, Secretary-General of the PSP, has explained this concept as follows:

> There is only one way of decolonizing colonial territories and that is by eliminating the intervention which produces that colonization. Since the United States undertook its intervention in Puerto Rico unilaterally, without having consulted the Puerto Rican people at all, by means of an armed invasion which subsequently was ratified in a treaty between two belligerents in a war, neither one of which was Puerto Rico; and inasmuch as it has constantly pursued its intervention in our country since then, crushing

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[3] This quotation and others in this section not attributed to individuals were taken from an English translation of the PSP 1980 electoral platform.

> the self-determination of the Puerto Rican people, the only way in which the United States can abide by mankind's mandate to decolonize Puerto Rico is by halting its intervention. Since there was no need for plebiscites, referendums or elections to carry out invasion, there is no ground to claim that they are necessary for the full and unconditional transfer of powers to the people of Puerto Rico.

The PSP is committed to boycott any plebiscite that takes place prior to a complete transfer of powers to Puerto Rico. It pledges to vigorously pursue national and international activities to prevent any such referendum which perpetuates what it considers to be the political, economic, and military subordination of Puerto Rico to the United States.

The PSP, however, urges Puerto Ricans to construct "a legal formula that will favor the most peaceful and least painful transition toward decolonization," consistent with the prior transfer of powers concept. Although reaffirming the pledge for a peaceful transition, Mr. Mari-Bras states that "we shall never refuse to confront the violence of the enemy with the violence of the Puerto Rican revolutionary spirit."

The PSP is steadfastly committed to independence as the only acceptable status. It firmly believes that complete autonomy is required to protect and nurture the island's culture, to institute a true democracy by the masses, and to enable Puerto Rico to attain control over its destiny.

[This section has been reprinted from the 1981 GAO report. It has not been updated.]

SECTION 9.—SELF-DETERMINATION ISSUES

Any status decision involves assessing a perplexing array of concerns. This section discusses how such decisions will affect

PUBLIC ADMINISTRATION AND POLITICAL ISSUES

Federal laws and programs:

—statehood would result in equal treatment
—Independence would result in far-reaching changes
—Enhanced commonwealth would maintain special arrangements with some effects unknown

Government services:

—statehood: responsibilities largely unaffected, with some qualification
—Independence: numerous adjustments and additional financing

Citizenship and nationality under independence:

—Who would continue to be U.S. citizens?
—What would be their nationality?
—What constitutional and judicial protections would remain?
—What would be the effect of immigration laws?

Congressional apportionment: decisions would have to be made under statehood
Political violence: scenarios debated for each status option

ECONOMIC DEVELOPMENT

Federal financial assistance:

—statehood would increase aid
—Independence would terminate federal assistance; alternative funding and beneficiaries vested rights would remain in question
—Enhanced commonwealth would seek greater discretion over use of federal funds and federal law

Tax environment, liability, and exemption:

—Tax liabilities and revenue structure uncertain under status options
—Tax environment characterized by income and property tax exemptions
—Eliminating corporate tax exemptions could threaten future business development

Other factors important to business:

—U.S. wage laws
—shipping costs
—Trade arrangements

—Capital costs and availability
—Energy costs

CULTURAL ENVIRONMENT

Language issues:

—Spanish language predominates historically
—Conducting federal court proceedings in Spanish is advocated
—Statehood admissions set historical precedence for language requirements

Legislation and measures exist for accommodating linguistic minorities
Status options propose various approaches to preserve Puerto Rico's language and culture

INTERNATIONAL STATUS

U.N. Committee considers Puerto Rico's status despite U.S. opposition
Hypotheses of international acceptance and autonomy advanced for each status option
Strategic defense issues surface with status debate

[This section has been selectively updated from the 1981 GAO report. Information contained in brackets has been updated.]

SECTION 9A.—POLITICAL AND PUBLIC ADMINISTRATION ISSUES

FEDERAL LAWS AND PROGRAMS

Present Treatment Similar to States, But Key Differences Exist

Puerto Rico's relationship with the Federal Government contains many special features, but it has developed similar to the Federal-State model. The island's duty-free access to U.S. markets and use of the dollar since the early 1900s have created a situation where almost three-fourths of Puerto Rico's trade is with the States. Since that time, the Federal Government also has provided Puerto Rico's defense and extended most U.S. laws to the island. Moreover, the advent of U.S. citizenship in 1917 prompted certain legal protections and enabled unrestricted migration to the States. Further, the island is treated like a State in the vast majority of Federal activities and assistance programs.

Several key departures from the traditional Federal-State relationship, however, also have contributed greatly to the island's development and revenue raising capacity. Federal tax advantages have played a key role in attracting investment—approximately 90 percent of Puerto Rico's industry reportedly has been financed by mainland-based firms. Also, since 1900, Puerto Rico's exclusion from most Federal internal revenue provisions has afforded the island government greater flexibility in establishing a local tax system. Another longstanding arrangement to provide government revenues is the Commonwealth's receipt of certain Federal excise taxes and customs collections.

On the other hand, although-treated like a State in almost all Federal assistance programs, Puerto Rico is either excluded or provided reduced funding levels in certain programs, such as Supplemental Security Income, and Elementary and Secondary Education. Such treatment has raised questions concerning the rights of U.S. citizens residing in Puerto Rico and has been addressed by the U.S. Supreme Court. The court, in two separate cases, rejected arguments that reduced funding levels and exclusion from certain Federal programs were unconstitutional.

In one case, the court concluded that the Congress may treat Puerto Rico differently from States as long as there is a rational basis, because the U.S. Constitution grants the Congress authority to make all needful rules and regulations respecting the territories. The court cited three reasons which it concluded justify different treatment: Puerto Rico residents do not contribute to the Federal Treasury; the cost of treating Puerto Rico as a State would be high; and additional amounts of Federal aid could disrupt the Puerto Rican economy.

Similarly, there are a few variations in how Federal services and regulations apply to Puerto Rico, although in most cases the island is treated like a State. One notable variation concerns Federal banking laws. For example, although national banks in one State generally are prohibited from opening branches in another State, Federal law permits, upon approval, national banks to operate branches in Puerto Rico. Additionally, the Interstate Commerce Act does not apply, and the Federal Trade Commission and the Bureaus of Census and Labor statistics do not provide the same coverage given to States.

Statehood Would Bring Equal Treatment Under Federal Laws And Programs

Statehood would not change most elements of the present relationship, because the island already is treated like a State in most Federal activities. Admission, however, would alter several key aspects of Puerto Rico's. relationship with the Federal Government.

Statehood would bring full equality in national political and legislative matters and end limitations on certain Federal programs where Puerto Rico is treated differently from States. Equal treatment under statehood, however, would eliminate Federal tax advantages which have been important to the island's development and government finances. Statehood advocates maintain that Puerto Rico's unprecedented situation warrants adjustment measures designed to facilitate a transition.

Because statehood would cause numerous adjustments important to the island's future, it would require careful consideration by the Congress and Puerto Rico. Consequently, statehood's aggregate impact would be influenced greatly by the terms of admission, strategies to promote economic development and replace current special tax arrangements, and decisions regarding the island government's revenue structure.

Independence Would Prompt Far-Reaching Changes

Independence would cause profound changes to virtually every aspect of Puerto Rico's relationship with the Federal government. Independence holds far-reaching impacts, because Puerto Rico's longstanding relationship with the United States has influenced significantly the island government's financing and economic posture in addition to having forged strong commercial and other ties to the remainder of the United States. Recognizing the magnitude and scope of change their status option entails, the Puerto Rican Independence Party (PIP) has advocated that autonomy be attained through an orderly and rational transition to self-reliance.

Eliminating the Extensive Federal Role: Potential Impacts and Advocates Proposals

Because autonomy would completely revamp the intricate federal-Puerto Rico relationship, independence's ultimate impact hinges on numerous future legal, fiscal, and other policy decisions by the Congress and Puerto Rico. The most notable decisions would entail the terms of independence; the financial structure and policies of the republic; and the new nation's success in concluding treaties with other countries and organizations concerning trade, financial assistance, and other arrangements. Other elements crucial to the new nation's development would include worldwide economic conditions and Puerto Rico's attractiveness as a place for investment.

Although the overall effects of independence cannot be measured with any certitude, elements that would change can be described and areas requiring detailed consideration delineated. The PIP has proposed certain arrangements it believes are indicative of the type needed to facilitate a transfer of powers.

Although Maintaining Special Arrangements, the Impact of Amended Commonwealth Proposals Hinges on Future Decisions

Although emphasizing that the basic framework of the current relationship be preserved, commonwealth proponents have advocated certain changes. They have proposed that common citizenship, currency, defense, and duty-free access to U.S. markets be continued along with exemptions from most internal revenue laws and rebates of alcohol and tobacco excise taxes and customs duties. Advocates have maintained, however, that certain arrangements need revising to give the island more flexible treatment in Federal laws and programs as well as greater control over several areas regulated by the Federal government.

Although proposals for an amended commonwealth have been made, the exact nature of any modifications are contingent upon future deliberations by commonwealth advocates and approval by the Congress. As for statehood and independence, the ultimate impact of an amended commonwealth hinges on the specific negotiated terms and subsequent policy decisions by the Puerto Rico government. Consequently, the best indication of what an amended commonwealth would entail, according to commonwealth advocates, could be obtained by examining proposals embodied in the 1975 Compact of Permanent Union and Governor Hernandez-Colon's 1979 "New Thesis."

Along with achieving more local control over spending Federal funds, amended commonwealth supporters have urged a greater voice in Federal legislation and activities affecting the island. One proposal designed to enhance Puerto Rico's influence over these matters is to grant the island representation in the U.S. Senate along with the House of Representatives. Another suggested modification has proposed that in the future:

—Puerto Rico would not be subject to Federal laws unless specifically mentioned;
—if mentioned in new Federal legislation and regulations the island would be authorized to object and have such objections acted upon by the Congress or the administering Federal agency; and
—Federal legislation and regulations already applicable to the island would be subject to review by a joint U.S.-Puerto Rico Commission.

This commission would (1) study the desirability of retaining, modifying, or eliminating the application of Federal laws, especially those pertaining to communications, shipping, and administration of the selective service, ((2) study the possible transfer of various Federal functions to Puerto Rico, and ((3) examine the desirability of making gradual contributory payments to the Federal Treasury when such payments would not impede the island's social and economic development.

If any Federal functions were assumed or payments to the Federal Treasury instituted, new financial obligations inherently would be created. The amount of additional costs, however, is contingent upon decisions regarding which activities would be affected as well as the exact arrangements made to finance new responsibilities and transfer any functions. Similarly, the impacts of any contributory payments cannot be gauged until the types and methods of remuneration are established.

Control Sought Over Broad Range of Federal Activities

While pressing for greater influence over future Federal actions, commonwealth proponents also have advocated amendments to increase Puerto Rico's control over several other areas. One such proposal was that all U.S. immigration laws and quotas continue to apply, but that when economic and demographic conditions warrant, the President and Puerto Rico's Governor could agree to limit or increase entry of aliens into the island.

Another proposed modification calls for increasing Puerto Rico's role in setting tariffs and quotas on goods entering the island. One such proposal was that Puerto Rico be able to levy, change, or eliminate such tariffs and quotas, so long as it was consistent with U.S. international obligations and laws as well as coordinated with the Federal government. The proposal also stated that the island would be accorded observer status on U.S. delegations negotiating international trade agreements and be consulted throughout the process. Further, the United States would, upon request, seek to have Puerto Rico recognized as a developing country qualified to receive preferences associated with that status.

Commonwealth supporters also have advocated that Puerto Rico be granted autonomy in establishing wage rates and other labor related factors along with primary control over the island's ecology. They further have proposed that Puerto Rico be permitted when consistent with U.S. policy to enter into commercial, technical, and other agreements with foreign countries and participate in international organizations.

All of these proposals are intended to strengthen the island's control over areas presently within Federal jurisdiction. They are advocated primarily as instruments to promote Puerto Rico's economic development.

GOVERNMENT SERVICES

Under Statehood, Most Federal and Puerto Rican Responsibilities Would Not be Affected, Although Some Would Need Attention

With few exceptions, Federal regulations and services applicable to States also apply to Puerto Rico. For example, the Federal Government provides postal, defense, customs, and immigration services and regulates areas such as occupational safety, aviation, the environment, and maritime shipping. Our analysis and discussion with officials in almost every Federal agency revealed that admission into the Union would not affect most services and regulations.

Certain areas in which Puerto Rico has been treated differently from States, however, would need attention. Services provided by the Federal Internal Revenue Service (IRS) would increase if the island became a State. Presently, IRS's Office of International Operations handles certain Federal tax matters in Puerto Rico, such as Social Security and excise taxes, but statehood would increase responsibilities for processing and auditing additional individual and corporate returns and collecting other taxes- An IRS official estimated that these added duties would require staff and resources equivalent to a small district office and could possibly cost about $18 million annually.

Because it is treated differently from States under certain U.S. banking laws, changes could be required if Puerto Rico is admitted to the Union. Most notably, although Federal law generally prohibits nationally chartered banks located in one

State from opening branches in another State, these banks—upon the Federal Reserve's approval—can open branches in Puerto Rico. Three large branches of mainland-based national banks—Chase Manhattan, Citibank, and Bank of America—have become important to the island's banking industry and economic development. These banks hold over one-third of total banking assets and deposits and finance almost half of the island's bank loans. Because this arrangement could be jeopardized if Puerto Rico became a State, it would need attention during any statehood deliberations.

Several other banking provisions also would require attention. All nationally chartered banks in the States are required to join the Federal Reserve System which, among other things, makes them insured banks under the Federal Deposit Insurance Act, but Puerto Rican branches of national banks are not. Also, such branches are not subject to Federal legislation pertaining to reserve requirements or interest rates on deposits. Further, limitations on certain interstate bank acquisitions have not been applied to Puerto Rico.

In addition to certain banking regulations, Puerto Rico is exempted from the Interstate Commerce Act. Statehood likely would have little effect in this area, however, because Puerto Rico has no railroads or interstate roads, and the island already is subject to Federal maritime laws.

Like Federal activities, Puerto Rico's government responsibilities likely would not be affected significantly by statehood. Discussions with Commonwealth officials and our review of available documents revealed that the island government already provides a full range of services comparable to those performed by State and local governments. As discussed in section 5, these services include education and public safety, along with highway construction and maintenance.

If Independent, Federal Services and Regulation Would Cease, Requiring Numerous Adjustments and Additional Financing

An independent Puerto Rico would have complete autonomy over its own affairs. The island no longer would be subject to Federal regulation or be the recipient of Federal services. Presently, the Federal Government regulates many areas, including shipping, immigration, communications, and the environment. Further, federally provided services include defense, postal, and census counts; and safety certifications of airplanes, drugs, and various other products.

Like the challenges of implementing a new economic system, however, the new nation would have to decide which federally administered activities would be assumed and how such new responsibilities would be managed and financed. The manner in which the new nation chooses to govern and finance its activities would not be known until its organization was formulated. Additionally, an independent Puerto Rico's governmental activities would be influenced by any arrangements made with the Federal Government to transfer the functions

The PIP has proposed that Federal postal facilities be transferred to the new government's postal agency and notes that efforts would be made to retain the same employees because of their expertise. The PIP also has advocated a bilateral treaty to maintain the present relations regarding international telephone, cable, radio, and television services after independence. A similar proposal has stated that until bilateral treaties are negotiated for air and marine lines, present service would continue temporarily under permits in effect before independence.

The PIP also has advocated the U.S. military's complete withdrawal and has called for negotiating the minimum time and conditions for vacating the island. The PIP, however, plans to demand the immediate cessation of activities on Vieques—an island off the coast of Puerto Rico. According to Ruben Berrios Martinez, a former President of the PIP, an independent Puerto Rico would not have armed forces other than a national guard.

In addition to negotiating the U.S. military's departure, the PIP has stressed that the real and personal property rights of American citizens and businesses would be honored and any exploitation justly compensated. They also have proposed that all U.S. Government property be given to the new republic In all, the U.S. Government owned 91,351 acres in Puerto Rico in 1981. Over 75,000 acres were acquired by either direct purchase, donation, or other means. Also, more than 15,000 acres were ceded to the United States by Spain in 1898.

CITIZENSHIP AND NATIONALITY

Independence Would Raise Complicated Issue Of Citizenship

If Puerto Rico chooses independence, questions will arise about continued U.S. citizenship of Puerto Ricans both on the island and the mainland. The effect of a new nation's formation on inhabitants' nationality or citizenship has been a complicated issue in international and domestic law. Some general principles exist, however, and the Puerto Rican Independence Party has made a proposal concerning this issue.

U.S. Courts Have Seldom Addressed Sovereignty Changes, But General Principles Exist

Although rarely addressed in U.S. courts, some principles have been formulated in cases involving conquest or cession of territory as well as domestic citizenship. At the end of the 19th century, the U.S. Supreme Court held that the nationality of a territory's inhabitants becomes that of the government under whose sovereignty they pass, subject to their right of election to retain their former nationality. In another case, the court held that every independent nation has the right to determine what classes of persons should be entitled to its citizenship in accordance with its own constitution.

Both these decisions are consistent with the view in international law that the predecessor State's law determines which persons have lost their nationality, and the newly independent stated's law determines which persons have acquired its nationality.

A corollary issue is determining which nationals or citizens are affected by a sovereignty change. Generally, this involves deciding whether the new status is conferred on persons domiciled in the new State, those born there regardless of domicile, or both. Although U.S. case law on this question is limited, a U.S. Court of Appeals suggested that domicile, at the time of a sovereignty change, was the crucial factor.

When the Republic of the Philippines achieved independence, questions arose regarding the continued U.S. nationality of its citizens. Although jurisprudence regarding the Philippines situation is minimal, a U.S. district court held that Philippines citizens lost their U.S. nationality immediately upon independence. The status of Philippines citizens, however, is not analogous to Puerto Ricans because most Filipinos were U.S. nationals at the time of independence, but not U.S. citizens.

The difference in legal status between U.S. nationality and citizenship is important. Citizenship is a status of constitutional dimension protected by the Fourteenth Amendment, while nationality is a status conferred by statutory law. In this regard, U.S. Supreme Court decisions have held that a U.S. citizen has a constitutional right to remain a citizen unless that status is voluntarily renounced.

In view of the constitutional and judicial protection conferred upon U.S. citizens, it is not clear what act or acts would constitute a voluntary renunciation. It could be argued that a formal individualized renunciation is necessary and that a change in sovereignty alone would not cause an automatic loss of U.S. citizenship.

International Treaty Provisions Have Resolved Nationality Problems

In the past when sovereignty changes occurred, treaty provisions often addressed nationality problems. For example, when Spain ceded Puerto Rico and other territories to the United States, the Treaty of Paris allowed territorial inhabitants to either retain their Spanish citizenship or adopt their territory's nationality. The treaty provided that inhabitants could preserve their Spanish citizenship by declaring their decision within 1 year. The absence of such a declaration was considered as renunciation of Spanish allegiance and adoption of the territory's nationality.

Some Citizenship Questions Addressed by Independence Party Proposal

Should Puerto Rico become an independent nation, an agreement between the United States and Puerto Rico on the citizenship question would seem probable. Some questions which most likely would be addressed include:

—Which Puerto Ricans would automatically be citizens of the new republic; those domiciled on the island, those born on the island and domiciled elsewhere, or both?

—Would citizens of the new republic automatically lose their U.S. citizenship, or would formal renunciation be necessary?

—Could citizens of the new republic also remain U.S. citizens? [Although the United States allows dual citizenship in some cases, it may neither be desired by an independent Puerto Rico nor reasonable to extend it to an entire population.]

—Which Puerto Ricans who are not automatically citizens of the new republic would be given the choice of becoming citizens?

—What formal procedures for choosing and renouncing citizenship would be established?

The PIP's 1980 political platform contains a proposal regarding citizenship. The proposal states that U.S. citizens born in Puerto Rico and residing on the island at the time of independence will become citizens of Puerto Rico unless they desire to retain their U.S. citizenship. Those persons who declare this desire within 6 months of independence would acquire the status of resident foreigner. Resident foreigners would be guaranteed personal and property rights, but not political rights or the right to occupy public offices.

The proposal further states that U.S. citizens residing in Puerto Rico, but not born on the island, could request Puerto Rican citizenship. Additionally, Puerto Ricans residing outside Puerto Rico at the time of independence would be allowed to become Puerto Rican citizens within 1 year of independence. If year has passed these persons could apply for Puerto Rican citizenship after residing on the island for 1 year.

This proposal appears generally consistent with principles of international and domestic law because (1) it allows for choice and (2) place of domicile is the determining factor. Although the PIP proposal does address many elements of the citizenship question, resolution of this issue could only be accomplished through negotiation between Puerto Rico and the U.S. Government.

A Change in Citizenship Could Affect Unrestricted Migration

Another consideration related to citizenship is Puerto Rican migration to the U.S. mainland. Common citizenship has fostered close ties between Puerto Rico and the remainder of the United States and has afforded Puerto Ricans unrestricted access to the States for employment and other reasons Puerto Rican migration has helped the island's overcrowding, possibly alleviating some economic problems. Although the large net outmigration of the 1950s and 1960s has ended, Puerto Ricans continue to move between the island and the mainland in great numbers.

Losing U.S. citizenship may result in limiting migration, because an independent Puerto Rico would likely be subject to U.S. immigration laws. In this regard, the PIP calls for the U.S. government to grant an annual Puerto Rico immigration quota for 10 years after the republic is established. Like other areas, however, the impact on migration would depend on the negotiated terms of independence.

CONGRESSIONAL APPORTIONMENT

Statehood Would Present Congressional Apportionment Decision

Should Puerto Rico be admitted as a State, the Congress could either reapportion the present 435 House of Representatives seats or increase the House size to accommodate the new State's representation. [Because its population was greater than 25-states in 1986, the island would have been eligible for representation equal to or greater than half the States. In a 1989 report Congressional Research Service estimated Puerto Rico would receive up to six seats.]

U.S. Constitution Provides Basis for State Representation

Congressional composition was discussed widely at the 1787 Constitutional Convention. Conflicts between large and small States led to the compromise arrangement which provides equal State representation in the Senate, while representation in the House of Representatives is apportioned according to each State's population.

The U.S. Constitution established representation for the first Congress and prescribed that regular censuses provide the population basis for subsequent apportionments. Additionally, the constitution provides that each State have at least 1 member of the House of Representatives, and the maximum number of representatives cannot exceed 1 for every 30,000 persons.

Increases Occurred Frequently in the House Size Until 1912

The admission of new States and population increases caused the House of Representatives to grow from 65 members representing 13 States to 435 members representing 50 States. New States' admission or enabling acts normally prescribed at least one representative until the next apportionment. Apportionment acts from 1850 to 1911 allowed for increasing the House size should a new State be admitted, and House membership was increased following each decennial census until 1911.

In that year an apportionment act fixed House membership at 433 and provided that Arizona and New Mexico each have one representative should they become States. In 1912 both were admitted and the House size set at the present 435. Although a 1929 act changed the method for apportionment, it did not change the House size.

Since 1929 only two States have been admitted—Alaska and Hawaii in 1959. Their admission acts entitled them to one representative until the next reapportion-ment, temporarily increasing House membership to 437. Following the 1960 census, however, the House was reapportioned, dividing the 435 seats among the 50 States. The 1929 act, as amended, continues to dictate apportionment despite numerous attempts to increase the House size.

POLITICAL VIOLENCE

Sporadic Politically Motivated Violence Presents An Uncertain Factor In Resolving Status Controversy

Like many other areas throughout the world, Puerto Rico's history has included isolated incidents of political violence. Because these incidents have been described as generally stemming from dissatisfaction with the island's political status, the present debate has included discussing the potential for future violence. This possibility, however, is afforded varied significance by the different status proponents. Whether violence would increase is speculative, but past history makes it a factor with uncertain dimensions in attempting to resolve the island's status controversy.

Dissatisfaction with Political Status has Caused Isolated Incidents of Violence

Puerto Rican dissatisfaction with Spain's authoritarian control led to a powerful home rule movement in the 1800s. Although most Puerto Ricans sought to gain greater autonomy peacefully, a small separatist movement emerged, and several isolated uprisings occurred. One such occurrence in 1868, the "Grito de Lares," is generally considered a symbol of the pro-independence struggle and is celebrated as a local holiday to mark the' revolt against Spain. By the end of the 19th century, Puerto Rico had obtained greater participation in managing its own affairs through the Charter of 1897, but the Spanish-American War ended Spain's rule.

Although most islanders were hopeful that U.S. presence would bring improvement, dissatisfaction with U.S. policies began to grow in the early 20th century. During this time a small group of anti-American residents formed the Nationalist Association.' and embarked on a campaign to invoke independence sentiment. The nationalists, frustrated in their peaceful attempts, became increasingly hostile in the 1930s to dramatize their cause. Along with the turmoil caused by this group's violent actions, the island was also suffering the depression's severe economic hardships.

The latter part of the 1930s witnessed further nationalist violence. Following the 1936 assassination of a police chief and subsequent police retaliation, in 1937 the Ponce Massacre occurred, which left 19 dead and more than 100 injured. Attempts were also made to assassinate a Federal judge in Puerto Rico and the island's appointed governor. These terrorist attacks were widely condemned in both Puerto Rico and the states.

During the movement for commonwealth status the nationalists again launched a terrorist campaign on the island and the U.S. mainland. In 1950 nationalists attempted to force their way into the Governor's mansion in San Juan while simultaneous uprisings occurred in six other Puerto Rican towns. Two days later, an attempt was made to assassinate President Harry S. Truman by two mainland Puerto Ricans, who were part of the Nationalist movement.

After these attacks the then Governor and Puerto Rican press expressed their sorrow, emphasizing that the small nationalist group had little sympathy from the vast majority of Puerto Ricans. Many mainland newspapers also urged that the nationalist uprising be kept in perspective and that it not affect the upcoming commonwealth status.

In 1954 Nationalists wounded five Congressmen on the floor of the U.S. House of Representatives, Many arrests and convictions followed these incidents, and the Nationalist organization dissipated.

Other terrorist groups seeking independence, however, have surfaced. Consequently, politically motivated crimes continue to occur sporadically both in Puerto Rico and the states. In 1979, groups espousing independence claimed responsibility for attacking U.S. military personnel in Puerto Rico, killing several people. Also, many bombing incidents in the 1970s and other violence on the mainland resulting in several deaths are believed linked to a clandestine terrorist Organization dedicated to Puerto Rican independence.

Possibility of Increased Violence Discussed

Politically motivated violence has occurred sporadically and the possibility of continued violence has been raised by many different persons. Although most consider political violence a possibility, its extent and importance is given different weight.

Representatives from anti-statehood political parties have repeatedly made statements that statehood for Puerto Rico would unquestionably result in increased violence. They believe that attempts to resist assimilation would result in numerous violent attacks both in Puerto Rico and the United States.

Statehood supporters believe that violent incidents are not representative of the island's political sentiment or stability and that the status question should not be affected by criminal actions and threats of a few. Puerto Rico's pro-statehood former Governor has stated there is no reason whatsoever to believe that the advent of statehood would result in any significant upsurge in violence. He has further suggested that violence has tended to historically increase as a colony moved towards independence because of infighting among groups striving to lead the government, whereas colonies moving towards integration have remained tranquil.

Federal Bureau of Investigation officials in both Washington and Puerto Rico believe the number of Puerto Ricans involved in political violence is small, and most island residents do not support this type of activity. Further, they believed it difficult to predict whether there would be any increase engendered by a status change.

[This section has been selectively updated from the 1981 GAO report. Information contained in brackets has been updated.]

SECTION 9B—ECONOMIC DEVELOPMENT

FEDERAL FINANCIAL ASSISTANCE

Current Relationship Prompted Integral Fiscal Role Of The Federal Government

The island's relationship with the U.S. Government and historic growth in Federal activities have contributed to the extensive federal role in Puerto Rico. Table 9b.1 illustrates the changing importance of Federal disbursements.

Table 9b.1—FEDERAL EXPENDITURE IN PUERTO RICO (1975–1979)

[In millions of dollars]

	1975	1979	1975-1979 Percent increase
Net transfer payments	$599	$1,483	148
Federal grants to the government sector [1]	797	1,423	79
Total Federal assistance	1,396	2,906	108
Operating expenditures of Federal agencies in Puerto Rico	188	258	37
Federal assistance as a percent of island gross product	20	29	

[1] Includes certain customs duties and Federal alcohol and tobacco excise tax rebates.

Source: Economic Report to the Governor, 1979.

Table 9b.2—FEDERAL EXPENDITURE IN PUERTO RICO (1980–1988) [1]

[In millions of dollars]

	1980	1988	1980-1988 Percent increase
Net transfer payments	$1,606	$2,322	44.6
Federal grants to the government sector [2]	1,320	1,199	−9.2
Total Federal assistance	2,926	3,521	20.0
Operating expenditures of Federal agencies in Puerto Rico	277	684	146.9
Federal assistance as a percent of island gross product	28	20	

[1] Data in tables 9b.1 and 9b.2 were derived from different sources and therefore we did not make a comparison.

[2] Includes certain customs duties and Federal alcohol and tobacco excise tax rebates.

Source: Preliminary Report of the Economy of Puerto Rico, 1988.

Federal disbursements, as they do in states, substantially affect government finances as well as island residents' personal income and contribute significantly to Puerto Ricans' education, health, income security, housing, and employment opportunities. [For example, about 21 percent of the island's 1988 personal income and 31 percent of 1987 commonwealth government annual receipts came from Federal intergovernmental grant-in-aid programs.]

The Federal role has other dimensions. In addition to the importance of its tax policies, the Federal Government employs several thousand persons and spends [over $683 million] to run its island operations. Additionally, Federal loans and guarantees constituted an important source of capital.

Under Statehood, Increased Aid Would Benefit Island Governments and Low-Income Residents

In 1979, Puerto Rico already was fully eligible for the vast majority of the over 1,000 Federal assistance programs available to individuals and state and local governments. Although like states, Puerto Rico was not eligible for some programs targeted to a geographic area or specific group, the island was treated differently from states in certain major programs. In fiscal year 1979 there were 20 Federal programs that excluded the island or limited Puerto Rico's participation. Although treatment as a state would have had a minimal or unquantifiable effect under 14 of these programs, it would have brought substantial additional amounts under the remaining 6.

As illustrated in table 9b.3 Puerto Rico would have received about $836 million in additional Federal aid if it had been a state in 1984.

Table 9b.3—CHARACTERISTICS OF UNEQUAL TREATMENT AND ESTIMATED ADDITIONAL FEDERAL ASSISTANCE IN 1984 HAD PUERTO RICO BEEN TREATED LIKE A STATE

Federal Department	Program	How Puerto Rico's treatment differs from states	Estimated additional assistance under statehood (millions of dollars)
Education	Elementary and secondary education (Title I)	Different allocation formula applied	$68
Health and Human Services	Supplemental Security Income (SSI)	Excluded	404
	Aid to Families with Dependent Children (AFDC)	Federal matching rate set at 75 percent and island funding subject to a ceiling for fiscal year 1979	82
	Social Services (Title XX of Social Security Act)	Instead of being included in the formula $15 million are set aside for Puerto Rico	24
	Medicaid (Medical Assistance Program Title XIX of Social Security Act)	Matching rate set at 50 percent and island fund subject to a ceiling in fiscal year 1979	227
Agriculture	Food Stamp Program (Food Stamp Act of 1964)	Separate block grant subject to a ceiling	[1] 194
Earned Income Credit payments			31
Total			836

[1] Net of projected reduction in Food Stamps due to projected increases in SSI and AFDC payments.

The actual increased amount of Federal aid which could accrue under statehood, however, would depend on various factors including

—any changes to the authorization, allocation methods, or funding levels of programs where Puerto Rico is treated differently from states;

—budgetary decisions by the commonwealth government regarding expenditure levels in programs where the Federal Government reimburses or matches local costs; and

—specific terms of any admission legislation.

Because most of the programs which would have been affected by statehood were targeted for low-income persons; funding increases would have benefited less advantaged island residents. Additional funds under the Supplemental Security Income (SSI) program would have directly increased the income of needy aged, blind, or disabled persons. Similarly, increased Federal funds under Medicaid, Aid To Families With Dependent Children (AFDC) Child Support Enforcement, and Title XX of the Social Security Act would have been available to help state or local agencies assist low-income residents. [As we reported in our 1987 report on extending benefits to the territories, Federal costs under these programs would have doubled from about $1 billion to about $2.1 billion in 1984.] [1]

The overall increase in Federal aid brought by statehood would have raised the island's 1979 per capita share of total Federal outlays (domestic and defense) closer to that of the lowest state. On a per capita basis, Puerto Rico's actual Federal share in 1979 was much lower than any state, primarily due to its unequal treatment in several programs and the relatively small amount of defense expenditures. Any increased aid brought by statehood would improve the island's standing, and advocates have further contended that a stronger voice in Federal legislation through full congressional representation could result in additional funds.

Under Independence, Federal Assistance Would Terminate, but Questions Surface Regarding Alternative Funding and Beneficiaries' Vested Rights

Because Federal assistance has become increasingly important, making up for the loss of such integral and longstanding funding sources would present a key challenge to the new nation. An independent Puerto Rico would no longer automatically be eligible for the Federal assistance currently received. These funds, [amounting to about $3.8 billion in 1988], have contributed significantly to Puerto Ricans' income and, as illustrated in table 9b.4, are important to government services.

[Table 9b.4:]—FEDERAL CONTRIBUTION TO KEY PUERTO RICO SERVICES, 1989

Services	Percent of total 1988 program funds
Social welfare	28.3
Education	24.1
Housing [1]	1.0
Health	5.3

[1] Does not include grants to the Puerto Rico's Health Facilities and Services Administration.

Source: Bond Prospectus, Commonwealth of Puerto Rico, February 15, 1989.

Recognizing the consequences of suddenly losing Federal funds, the Puerto Rican Independence Party (PIP) has proposed that current funding levels be extended temporarily after independence. In lieu of the current forms of aid, however, the PIP has suggested that the Federal Government contribute to a special Development and Economic Reconstruction Fund. This fund would help finance essential government activities until the economy is reoriented, consumption patterns reduced, and other revenue sources developed.

This U.S. foreign aid would be requested for a 10-year period and decrease each year. Concomitantly, the independent nation, faced with steadily decreasing Federal assistance, would be confronted with decisions regarding levels and types of taxation and public services. Another important factor in counteracting the loss of federal program funds could be additional foreign aid from other countries and international organizations.

Island residents' vested rights acquired through contributions to certain Federal activities would require special attention. For example, Puerto Ricans, like other U.S. citizens, have paid into the Social Security Trust Fund and served in the Armed Forces or Civil Service.

The PIP has proposed that current beneficiaries continue receiving payments after independence under the same conditions as U.S. residents. Additionally, the proposed arrangement regarding Social Security calls for returning all payments, including interest, made by Puerto Ricans who had not yet received any benefits. The moneys would be used to establish a Puerto Rican Social Security System.

Commonwealth Advocates Seek Discretion in Using Federal Funds and Greater Influence Over Federal Law

Commonwealth advocates have proposed changing the manner in which certain Federal funds are provided to Puerto Rico's government. As an alternative to present Federal assistance which is targeted for use in specified programs and projects, amended commonwealth proponents have advocated that certain grants-in-aid be consolidated into a block grant. They have argued that such treatment would result in greater local discretion in determining how these funds are spent. Although the method for distributing aid to the Commonwealth government would be altered, programs such as Food Stamps and Medicare, along with payments to social security, civil service, veterans, and other beneficiaries, would continue unchanged.

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[1] Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, American Samoa," GAO/HRD-87-60, September 15, 1987.

TAX ENVIRONMENT, LIABILITY, AND EXEMPTION

Under Statehood, Immediate Equal Treatment Would Greatly Increase Tax Liabilities And Likely Prompt Major Realignments in Puerto Rico's Revenue Structure

Along with extending additional Federal funds, immediate equal treatment under statehood would engender profound changes to overall taxation in Puerto Rico. Although certain Federal taxes apply, for the most part Puerto Rico is not integrated into the federal internal revenue system. In the absence of full Federal taxation, the Commonwealth government developed a tax system more akin to that of the Federal Government than those of states. Equal treatment would bring full Federal tax liabilities and likely necessitate adjustments to Puerto Rico's tax system to make it compatible with the Federal one. The potential repercussions of such changes would necessitate deliberations by the Congress and Puerto Rico, along with numerous policy decisions regarding the scope of government services and the sources tapped to finance such activities. Recognizing the major adjustments associated with immediate changes to current tax arrangements, statehood proponents have argued that a 20-year transitional period be included in any admission legislation so that the Federal tax system could be phased in gradually. Although exempted from most U.S. taxes, Puerto Rico residents already are subject to Federal social security and unemployment taxation. Individual and corporate income earned outside of Puerto Rico as well as salaries of Federal employees working on the island also are taxed. Customs duties on foreign goods imported into Puerto Rico are applied fully as are Federal excise taxes on island-produced alcohol and tobacco products on mainland-bound shipments. Statehood would not affect the application of these taxes, but equal treatment would end the current arrangement whereby excise tax and customs duty collections less administrative costs are returned to Puerto Rico. Curtailing these rebates, [which amounted to $319.2 million in 1987] would decrease commonwealth government revenues while increasing Federal receipts.

Immediately imposing full Federal taxation would increase substantially Puerto Rico's overall tax liability. The island is in effect exempt from Federal individual and corporate taxes on income earned in Puerto Rico along with certain excise and estate and gift taxes. If Puerto Rico had been treated like a state [in tax year 1983, its liability would have been an estimated $2.4 billion] more but this fails to- account for potentially reduced revenue that could result from businesses losing their tax advantages leaving Puerto Rico.

The estimated increased Federal taxes would have stemmed primarily from the estimated [$2.1 billion] corporate liability and would have reflected, in part, the substantial profits of U.S. mainland based firms operating in Puerto Rico [in tax year 1983]. In 1979 Puerto Rico would have had a greater Federal corporate income tax liability than similar liabilities in 34 states. The U.S. Treasury Department estimated that mainland-based tax exempt firms alone [had fiscal year 1982 federal tax savings of $1.7 billion].

The future corporate income tax liability under statehood however, could be influenced greatly by decisions regarding investment in Puerto Rico. Mainland-based firms have been important to Puerto Rico's economy. Statehood's potential positive and negative influences on business decisions is a fundamental question surrounding the status debate.

The island's Federal individual income tax liability would have increased by $248 million in 1979 on the basis of our calculations from the latest available Puerto Rican tax return compilations. In contrast to the corporate levy, however, the island individual liability would have been less than any state. Because of Puerto Rico's extremely law per capita income, about 43 percent of the Puerto Rican tax returns used in our analysis in 1979 would have had no Federal tax liability.[2]

In fact, about 70 percent of these Puerto Rican returns could have been eligible for an estimated total of $36 million in earned income credits in 1979. The earned income credit is one of several Federal tax code changes which have significantly influenced the tax liability of lower income taxpayers since 1975. Others include increases in the personal exemption allowances and the zero income tax bracket along with decreases in overall tax rates.

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[2] Sixteen percent of island individual tax returns filed in fiscal year 1979 had no commonwealth tax liability.

In addition to increased corporate and individual income taxes, Puerto Rico residents also would have to pay estate and gift taxes along with additional excise taxes. During 1979 the island would have owed about $19 million in estate and gift taxes and approximately $146 million in added Federal excise levies on items such as gasoline and telephone services.

In conjunction with immediate equal treatment under the Federal tax system, statehood likely would prompt major changes to the island government's revenue system. For example, had it been a state [in 1987], the island would not have received the [$319.2 million] in Federal excise tax and customs duty rebates. Such lost revenue, however, would have been replaced by the estimated increased Federal aid under statehood. Although much of this aid would have been paid to individuals or targeted to increase funding in existing services, there would have been Puerto Rican government funds freed up by the changed Federal share in Medicaid, AFDC, and SSI.

The additional Federal aid would have offset the loss-of rebates, but the Commonwealth government in 1979 likely would have had to collect about the same amount of tax revenue if the range of public services were to be adequately maintained. As a state, however, Puerto Rico likely would have to change its tax system because island levies are similar to Federal taxes rather than those of state and local governments. Like in the Federal tax system, island individual and corporate income and excise levies are the major revenue producers, but Puerto Rican tax rates in many cases are higher. In contrast, property and sales taxes are the revenue mainstays of state and local governments, and income tax rates are considerably lower than the Federal ones.

Consequently, as a state, Puerto Rico would have to adjust its revenue system to make it compatible with the Federal one. Full federal taxation likely would necessitate reducing Puerto Rican taxes in categories where Federal levies exist. To compensate for any decreases, revenue would have to be obtained from other sources to maintain government services.

Obtaining sufficient revenues to maintain the level of Puerto Rican government services while making the island tax system compatible with the Federal one present major considerations. Hypothetically, if full Federal taxation had been imposed in addition to Puerto Rico levies, the island's overall 1979 tax liability would have increased by an estimated 66 percent, primarily due to the additional Federal corporate income tax liability. Excluding this tax, the island's total liability would have increased by approximately 17 percent. If it becomes a state, however, Puerto Rico's actual tax liability would depend upon various elements. Most notable would be any changes to U.S. tax laws and the tax structure adopted by the new state. Other important determinants would be the terms of statehood legislation, along with budgetary decisions regarding the island government's revenue system and the scope of public services. Additional factors would include economic conditions and the Puerto Rico government's financial posture.[3]

Another potentially significant but highly speculative element which could affect Puerto Rico's tax liability is the island's tax compliance difficulties. Although the Puerto Rico Treasury Department has intensified enforcement efforts, compliance with island tax laws reportedly remains a problem. Some observers believe that the Federal IRS with its greater resources might improve tax compliance.

Although IRS might increase island tax compliance and total collections, there would be no way to accurately gauge the magnitude of improvements until the agency began full operations. A representative picture of Puerto Rican tax compliance would probably not be available for several years, because it would take time to inform the populace about Federal tax requirements. Accordingly, we did not adjust our tax liability-calculations to include prospective increased compliance levels, but improved collection efforts could be a factor influencing the island's tax liability should it attain statehood.

Statehood Proponents Have Advocated Gradual Application of Full Federal Taxation and Other Transitional Measures

Statehood supporters have recognized that their status option would bring increased Federal taxes and eliminate excise tax and customs duty rebates to the Puerto Rico government. They have asserted, however, that because Puerto Rico would be the first new state not already incorporated into the Federal internal revenue system, gradual introduction of Federal taxation would be logical and necessary.

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[3] See Section 6 for a discussion of governmental finances in Puerto Rico

Specifically, statehood advocates have suggested a 20-year transition period. During this time, Federal individual and corporate taxes gradually would be phased in while comparable Puerto Rico levies are reduced to approximate those in states. Similarly, proponents have suggested that rebates of Federal customs duties and excise taxes be phased out incrementally. It also has been proposed that corporations be permitted to retain their Federal tax advantage until the corresponding Puerto Rican tax waiver expires.

Other examples of proposals to help the new state adjust its revenue system include various forms of transitional assistance ranging from special monetary aid and land grants to setting aside Federal contracts for manufacturing firms in Puerto Rico. Statehood advocates also have suggested that the Federal government assume the 1979 Puerto Rico public debt of $6.4 billion.[4] Servicing this debt cost about $700 million in 1979. This, it has been asserted, would permit channeling of local resources into satisfying the infrastructure requirements of a post-statehood economy and would free the State government from a large fixed expense during a period when major shifts in revenue sources would be taking place.

Exemptions From Income and Property Taxes Highlight Puerto Rico's Tax Environment

Puerto Rico's tax environment has been a major attraction to business since 1948, when the island began offering qualified local, U.S., and foreign firms—primarily in the manufacturing sector—exemptions from Puerto Rican income, property, and municipal taxes. This program complemented existing Federal legislation which exempted from Federal taxation earnings of certain mainland-based firms operating in Puerto Rico. Considerable tax exemptions remain in effect, but certain important changes have been made at both the Federal and Puerto Rico levels.

The Federal tax exemption provision, formerly section 262 of the Revenue Act of 1921, was made section 931 of the 1954 Internal Revenue Code. Under section 931, qualifying U.S. corporations could operate in Puerto Rico without paying Federal taxes on income earned there and on income derived from investing those earnings in Puerto Rico and foreign countries.

Businesses saw a major drawback in section 931, however, because dividends paid by a Puerto Rican subsidiary to a U.S. parent corporation were taxable. To avoid this taxation, a subsidiary typically accumulated earnings from its Puerto Rico operations and often invested them overseas until the tax exemption expired. At that time, the subsidiary would be liquidated into its parent because such liquidations were free from any Federal or Puerto Rico income tax.

Between 1973 and 1976 a congressional committee considered eliminating the exemption. Subsequently, another committee required an annual report from the U.S. Department of the Treasury on the provisions operation. Additionally, through the 1976 Tax Reform Act, the Congress made several changes and moved the tax exemption provision from section 931 to section 936 of the Internal Revenue Code. Foreign income of U.S. corporations' Puerto Rico subsidiaries, known as possessions corporations, was made taxable, and parent corporations could receive dividends from their Puerto Rico subsidiaries tax free. This was done in part because of concern about U.S. corporations' Puerto Rico subsidiaries investing their profits outside the states.

Anticipating the revision of the U.S. Internal Revenue Code, Puerto Rico changed its method for taxing the dividends paid to parent corporations by tax exempt firms. Prior to 1976 the rate of this tax (known as the tollgate tax) was 15 percent, but collections were small because it applied only if the parent could claim a foreign tax credit. Subsequently, Puerto Rico reduced its tollgate tax to 10 percent, and the tax applied even if the parent was denied a foreign tax credit.

The 10 percent tollgate tax could be reduced to 7 percent if 25 percent of a year's industrial development income was invested in certain ways for 8 years and to 5 percent if 50 percent of such income was invested in certain instruments for 5 years. Also, liquidating dividends of post 1977 industrial development income would be subject to a 4 percent tollgate tax.

Before 1978 possessions corporations paid virtually no dividends to their U.S. parents. During that year, however, possessions corporations distributed to their U.S. parents $1.5 billion. Puerto Rico estimated that dividend repatriation in both 1979 and 1980 was $1.7 billion. [Estimated tax benefits for tax year 1982 totaled $1.7 billion. The tollgate tax amounted to $89 million in 1982 and about $120 million in 1987]

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[4] [1988 public debt in Puerto Rico was about $11.2 billion. See section 6 for additional information.]

Additionally, in June 1978 Puerto Rico altered its longstanding policy of offering total tax exemption to qualified corporations. A revised Industrial Incentives Act required that firms receiving new exemption grants pay taxed on part of their earnings. The act also offered firms exemption period extensions and certain other inducements to encourage conversion to the new law and partial taxation.

Two main reasons for enacting the law were (1) the Commonwealth government's need for additional revenues to develop the island's infrastructure, and (2) the government's desire to eliminate the inequity whereby individuals bear the largest share of the tax burden while many corporation paid no taxes. Puerto Rico's Economic Development Administration, for example, estimated that exempt profits increased from 0.6 percent of net manufacturing income in 1948 to 71.2 percent in 1976. [In inflation-corrected dollars, net income in 1982 amounted to 295 percent of income in 1974 according to the Federal Treasury's 1985 report on the Possessions Corporation System of Taxation].

The act primarily affected larger firms, most of which were U.S subsidiaries, because it totally exempted the first $100,000 of a firm's income if it earned less than $500,000. We were informed that more than 95 percent of all local tax exempt manufacturing firms earn less than $500,000 annually, and about half of these firms earn less than $100,000.

The tax exemptions offered under the act are still significant, beginning at 90 percent and decreasing gradually over the life of the grant as shown in table 9b.5.

Table 9b.5—PUERTO RICO CORPORATE INCOME TAX EXEMPTION SCHEDULE, 1980

Year of grant	Percent of income exempt from income and property taxes	Approximate maximum effective income tax rate
1-5	90	4.50
6-10	75	11.25
11-15	65	15.75
16-20	55	20.25
21-25	50	22.50

Depending on the zone in which it locates, a firm receives an initial exemption of 10 to 25 years. In addition, the firm can apply for an extension of 10 years with a 50-percent exemption for the first 5 years and between 35 and 50 percent for the next 5 years. The act also encouraged conversions of existing tax exemption grants by offering 10-year extensions in return for becoming partially taxable. Some of the other major provisions of the act gave special exemptions to certain industries and allowed alternative ways to calculate taxes in certain circumstances.

Although the act required paying some taxes, many holders of existing exemption grants requested conversion. The combination of Federal and local exemptions still represents significant incentives unavailable in the states. Over 500 applications—about one-third of existing grants—were received. The Commonwealth government estimated that tax revenues under the new act would be about $10 million in 1981 and rise to about $45 million in 1985. The 1987 Tax Incentives Act maintained the basic provisions of the earlier act.

Aside from firms operating under an exemption, businesses in Puerto Rico are taxed at rates similar to those levied by the federal government in 1979. The island's corporate tax structure is based on the U.S. Internal Revenue Code of 1939 and is comparable in many respects to the current Federal tax code. Corporate tax rates start at 22 percent of net income and rise to 45 percent on all income over $300,000. Federal corporate income tax rates begin at 17 percent and rise to 46 percent on all income in excess of $100,000. Additionally, Puerto Rico tax rates apply to gross income, less allowable deductions, which is defined in much the same way as the Federal tax code.

Each Status Option To Varying Degrees Would Affect the Liabilities of Taxable Firms

Although tax exemptions have been granted to many firms, primarily in the manufacturing sector, the vast majority of businesses (including corporations, partnerships, and proprietorships) pay full Puerto Rico taxes. For example, in 1977, of the approximately 14,100 firms operating on the island, over 12,700 (90 percent) were taxable. These included over 11,800 Puerto Rico businesses, about 880 mainland-based firms, and approximately 40 foreign enterprises. The Federal Census Bureau indicated there were 32,620 establishments in Puerto Rico in 1986.

Taxable firms are important to Puerto Rico's economy. They employed about 400,000 persons, or about 50 percent of island employment, and contributed $5.3 billion, or 49 percent of gross domestic product. As discussed below, each status alternative would have varying effects on the tax liabilities of these businesses.

Firms currently paying island taxes likely would not be affected substantially by statehood even though Federal levies would be applied fully. Presently, Puerto Rico and foreign firms, as well as U.S. firms operating under a section 936 exemption, are not required to pay Federal taxes on income earned from Puerto Rican sources, but the island taxes at rates comparable to the Federal ones. Additionally, although U.S. firms without a section 936 exemption are subject to Federal taxes, they can totally, or in large part, offset their Federal liability by claiming a foreign tax credit for Puerto Rico taxes paid.

Although any decision on how to make the Puerto Rico tax system compatible with the Federal one rests entirely with the commonwealth government, statehood likely would prompt substantial reductions in island corporate rates to approximate those in states. Because state tax rates are much lower than the federal counterpart—the average for all states is 6 percent—and state taxes paid are deducted from income subject to Federal tax, the combined federal-Puerto Rico liability for currently taxable businesses under statehood would likely approximate that of firms in the states and remain relatively close to the present island levy.

For example, if Puerto Rico adopted the average state tax rate of 6 percent, the effective combined Federal and island maximum tax rates would increase to 49 percent, or 4 percentage points higher than the current island maximum rate of 45 percent. Although the maximum combined Federal and Puerto Rico tax rates under statehood would total 52 percent, 46 and 6 percent respectively, firms would pay an effective rate of 49 percent because state taxes would be deductible from income subject to Federal taxation. Of course, if Puerto Rico becomes a state the actual tax liability of any firm would depend largely on the tax system adopted by the island government and the Federal tax system at that time.

Under independence, the island would be the primary jurisdiction to tax Puerto Rican source income. An independent Puerto Rico would be confronted with numerous decisions regarding its tax system, and it is impossible to determine with any certitude the type of corporate tax system the new nation might adopt. Any U.S. firm operating in Puerto Rico, however, most likely would be able to reduce its Federal liability by taking a foreign tax credit for any island taxes paid.

Amended commonwealth proposals have not suggested any fundamental changes in the tax arrangements between Puerto Rico and the Federal government. Like statehood and independence, however, any changes regarding the Puerto Rico tax system depend on future island government decisions.

Suddenly Eliminating Federal Corporate Tax Exemptions Would Entail Risks to Future Business Development in Puerto Rico

Although the number of tax exempt firms operating in Puerto Rico constituted only about 10 percent of all businesses, their contribution to the economy is much greater. Out of the 14,100 firms located on the island in 1977, only 1,360 were exempt from Federal and Puerto Rico taxes (607 mainland-based, 731 Puerto Rico, and 22 foreign). Ninety-four percent of these businesses, however, are concentrated in and make up most of the island's manufacturing industry—Puerto Rico's most important economic sector and largest contributor to island gross product. In the manufacturing sector during 1977, tax exempt firms accounted for about 87 percent of net profit, 71 percent of payroll costs, and 76 percent of employment. In total, tax exempt firms employed about 117,000 persons, or about 16 percent of total island employment.

Attracting mainland-based investment has been the corner-stone of Puerto Rico's industrial development strategy. In 1977 the approximately 590 U.S. tax exempt manufacturing firms accounted for 82 percent of that sector's net profit and 50 percent of its employment. Moreover, the U.S. Department of Commerce's Economic Study of Puerto Rico estimated that about 90 percent of the island's industry has been financed by mainland-based firms. The study also noted that in view of the lack of Puerto Rican capital formation, future manufacturing development will depend very heavily on capital inflows and that continuation of Federal tax exemption is "virtually the sine qua non for attracting more U.S. investment capital to Puerto Rican industry."

The combination of Puerto Rico and Federal tax exemption has been a powerful inducement for locating in Puerto Rico and has resulted in substantial tax savings for U.S. firms operating on the island. The U.S. Treasury Department estimated that in calendar year [1982] these firms had Federal tax savings of [$1.5 billion].

Much of this tax savings has accrued to the two leading growth industries in Puerto Rico, the predominantly mainland-based pharmaceutical and electrical and electronic equipment industries. For example, the effect of Puerto Rican tax exempt earnings on parent firm profits has been substantial for many pharmaceutical companies, comprising over half of some parent firms' total profits. As shown in table 9b.6, during 1982 pharmaceutical firms accounted for more than 49.6 percent of total U.S. tax savings, and the electrical and electronic equipment firms accounted for an additional 21.6 percent.

[Table 9b.6:]—MANUFACTURING INCOME AND RELATED TAX SAVINGS IN 1982 FOR SECTION 936 FIRMS

Industry	Income (In millions of dollars)	U.S. tax savings	
		Amount (In millions of dollars)	Percent of total
Pharmaceutical [1]	$2,054	$832	49.6
Electricla and electronic equipment	896	363	21.6
Food products	237	98	5.8
Chemicals	2,212	893	53.2
Apparel	102	42	2.5
All other	683	282	16.8
Total	4,130	1,678	100.0

[1] Pharmaceutical figures are also included in the chemicals figures and not added for totals in table.

Source: U.S. Treasury's June 1985 Annual Report on Possessions Corporations.

Tax exempt U.S. chemical (including pharmaceutical) and electrical and electronic equipment firms' contribution to the Puerto Rico economy has been substantial. During [1982] they employed over [40,000] persons and paid them about [$649] million. This was about [50 percent] of total manufacturing employment and [56.8 percent] of payroll.

The provision of the U.S. tax code exempting certain U.S. businesses from Federal taxation could be rescinded at any time. Additionally, equal treatment under tax laws brought by statehood would end Federal exemptions as would autonomy under independence. Of course, Puerto Rico under any status could continue to offer exemption from its taxes.

In the event of statehood, exempt mainland-based firms would become subject to Federal taxes. Their liability would increase from the 0 to 12 percent paid in 1979 Puerto Rican taxes [5] up to a maximum Federal rate of 46 percent as well as any island taxes imposed. The levels of Puerto Rico taxes would depend on whether or not the island government would continue to offer local exemptions and what corporate tax system they might adopt. Any island tax paid could be used to reduce income subject to Federal taxation.

Statehood also would increase substantially the tax liability of more than 700 Puerto Rican and foreign firms that are, exempt from Puerto Rico and Federal income taxes. The contribution of these firms to Puerto Rico's economy, although much smaller than U.S. firms, is important. They provided more than 23 percent of manufacturing employment and 21 percent of payroll in 1977.

Like for statehood, mainland-based firms operating under section 936 most likely would lose their exemption if Puerto Rico became an independent nation. Puerto Rico could continue to offer U.S. firms exemption from its taxes, but this would have little benefit without exemption also from U.S. taxes. Because the foreign tax credit most likely would remain in effect with independence, however, U.S. firms operating in Puerto Rico would be able to claim any taxes they pay to Puerto Rico as a credit against their Federal taxes. Additionally, local and foreign firms could still be granted Puerto Rican tax exemption, but it is unknown whether the independent nation could afford to grant widespread exemptions, because it would lose revenues and services currently provided by the Federal Government.

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[5] According to a June 1980 U.S. Treasury report, for certain firms which converted to partial taxation or applied for exemption under Puerto Rico's 1978 Industrial Incentives Act, the maximum corporate tax rate currently ranges from 3 to 12 percent but will increase gradually in 5-year increments. Firms with grants awarded prior to the 1978 act who have not converted, however, pay no income tax but are subject to the tollgate tax of up to 10 percent on dividends transferred to the parent corporations.

Because Federal tax exemption has promoted Puerto Rico's manufacturing sector and was a primary reason for many firms locating on the island, eliminating the Federal exemption would be difficult to overcome, particularly if it is rescinded suddenly. The loss of this exemption through statehood orindependence or under the current Commonwealth status, would reduce the island's ability to attract and retain businesses because profits would be decreased significantly.

In 1978 the Puerto Rico Economic Development Administration (FDA) analyzed tax exemption decrees. This study examined 149 cases in which firms were granted Puerto Rican tax exemptions in 1960-62 and actually established operations. Although FDA was unable to obtain the current status of operations in 46 cases, of the other 103 cases:

—62 had apparently discontinued operations;
—31 were still operating under an extension or modification of the original tax exemption grant; and
—10 were continuing in taxable status, with 6 paying taxes and 4 reporting losses.

EDA concluded that very few corporations continue as taxpaying operations in Puerto Rico once their exemptions expire. one of the reasons cited for this was the "tax shock" a firm experienced going from total tax exemption to full taxation.

Other analyses performed by FDA concluded that the maximum income tax rate Puerto Rico could impose on the tax exempt sector and still be attractive to business is about 18 percent. The *Economic Study of Puerto Rico* found that most manufacturing concerns contacted believed a maximum corporate rate of 20 to 25 percent could be applied while maintaining business activity on the island. Similarly, officials of the Puerto Rico Chamber of Commerce and the Puerto Rico Manufacturers Association said that most industries could afford only to pay some taxes in Puerto Rico.

One FDA economist has stated that if tax exemption were removed producers in Puerto Rico would have several alternatives: (1) they could produce abroad with cheaper labor, closer raw materials, and perhaps closer markets, (2) they could—produce on the mainland closer to most markets but with higher labor and tax costs, or (3) they could quit producing altogether. The analyst concluded that these alternatives implied a reduction in employment and profits in Puerto Rico, and some combination of them likely would occur unless other incentives were initiated to offset the loss of tax exemption.

Proponents of statehood and independence recognize the difficulties of suddenly losing tax exemptions but believe their status alternative offers the best framework for guiding future economic development. Statehood advocates believe the Puerto Rican economy has reached the point where industrial tax exemption can begin to be phased out. They believe statehood will increase political stability, heighten awareness of Puerto Rico, and lead to more industry locating on the island.

Statehood proponents believe that the revised industrial incentives act will demonstrate that business can operate in Puerto Rico paying its fair share of taxes and that business would be able to accommodate full taxation after a transition period of some 20 years. These officials believe that the Industrial Incentives Act of 1978 will ease the "tax shock" problem by phasing in taxes over the life of a firm's tax exemption grant. The government hopes that when exemptions expire, firms will continue to operate paying full taxes.

Independence advocates do not see a need for continued widescale industrial tax exemption, primarily because they would not make manufacturing the primary sector of the economy. Agriculture would be given more attention, and Puerto Rico would attempt to produce more of what it consumes. All existing tax exemptions would be phased out, and new exemptions would be granted selectively when needed for development.

Advocates of amended commonwealth maintain that, given Puerto Rico's lack of natural resources and large population, continued federal and local tax exemption is necessary to promote economic development and stimulate job creation. They believe that Puerto Rico always should have the flexibility to offer up to 100-percent exemption from taxes to any firm. They are opposed to the revised industrial incentives act because, in their opinion, it does not provide enough flexibility. For example, commonwealth advocates believe labor intensive industries should be given 100-percent tax exemption, but high profit industries like pharmaceuticals may require less to attract them to Puerto Rico.

OTHER FACTORS IMPORTANT TO BUSINESS

Although tax exemption has been an important incentive, it is not the only business location determinant. Other elements, such as labor availability and cost and political stability, also are key factors; and like tax exemption, their importance varies by industry and firm. Tax exemption allows a firm to retain a larger portion of its earnings, but it is only valuable to an enterprise operating profitably. The following segments discuss factors important to a firm's profitability—labor costs, shipping costs, trade relations, capital availability, and energy costs—and identifies whether and how they would be affected by a status change.

U.S. Wage Laws Would Apply Fully Under Statehood; Amended Commonwealth Proposals and Independence Would Bring Increased Local Control

Historically, a major factor attracting industry to Puerto Rico has been the relatively low cost of labor. The application of U.S. minimum wage standards to Puerto Rico and the extremely low wages paid in other countries, however, have narrowed the island's advantage. Though labor in Puerto Rico can no longer be characterized as cheap, it is still less expensive than on the U.S. mainland. [In 1985, average island manufacturing wages plus fringe benefits were only 51 percent of those in the states]. In addition, Puerto Rico's worker productivity and the total cost of fringe benefits compete favorably with the states.

The average hourly manufacturing wage in Puerto Rico is well below that of any state, but it has been rising more rapidly. Between 1950 and 1978, the average hourly wage in Puerto Rico increased 719 percent compared to 311 percent in the States. As a result Puerto Rico's economy has changed from one concentrating on low wage, low skill, labor-intensive industries to one approaching the structure of the U.S. economy.

In 1940 it was recognized that wages on the island were significantly lower than those in the United States. The 1940 amendments to the Fair Labor Standards Act (FLSA) provided that covered Puerto Rico employees would have their minimum wage determined by a wage order procedure rather than congressional fiat. This procedure established a series of committees to determine the Puerto Rican minimum wage for each industrial group without exceeding the U.S. statutory minimum, curtailing employment, or giving Puerto Rico competitive advantage over the states. Over the years, minimum wage rates for an increasing number of industries in Puerto Rico have attained parity with mainland minimums.

From 1952 to 1978 the average manufacturing wage increased from a level equal to 60 percent of the U.S. statutory minimum wage to one equal to 130 percent of the U.S. minimum wage. The Economic Study of Puerto Rico reported that, as of December 31, 1977, about two-thirds of all Puerto Rico workers covered by FLSA were eligible for the U.S. minimum wage. The 1977 amendments to the act provided the means to bring most of the remaining covered workers up to parity with the U.S. minimum wage.

An indication of Puerto Rico's competitive wage advantage relative to the States is shown in table 9b.7.

Table 9b.7—AVERAGE HOURLY MANUFACTURING WAGE IN 1978

	All Mfg	Apparel	Chemicals	Equipment
U.S. average	$6.17	$3.94	$7.01	$5.83
Michigan	8.13	NA	7.79	7.16
Ohio	7.29	4.24	6.97	6.50
California	6.43	4.03	7.22	5.94
Louisiana	6.42	3.44	9.06	6.53
New Jersey	6.20	4.73	7.12	6.05
Florida	5.01	3.44	6.29	5.13
Georgia	4.88	3.47	5.87	5.50
Mississippi	4.56	3.34	5.79	5.03
North Carolina	4.47	3.44	5.58	4.91
Puerto Rico	3.44	2.80	4.60	3.69

NA—Not Available

Puerto Rico continues to maintain its competitive wage advantage.[6]

Fringe benefits also affect labor costs, and a high level of mandatory fringe benefits exists in Puerto Rico, including Federal requirements for unemployment compensation and Social Security. A study conducted for the Governor's Advisory Council on Labor Policy, which covered office and production employees not exempt from FLSA, concluded that the average cost of mandated fringe benefits in Puerto Rico was equal to 21 percent of firm's payroll compared to 8.8 percent in the states in 1979.

When the study considered all fringe benefits, both mandatory and voluntary benefits, however, total island fringe benefits averaged about 31 percent of a firm's payroll compared to 36 percent in the States. [By 1986, this gap increased slightly. The Economic Development Administration (FDA) of the Commonwealth of Puerto Rico estimated the cost of all fringe benefits in manufacturing in March 1985 averaged about 31 percent of payroll in Puerto Rico compared with 39 percent of payroll on the mainland].

Although wage rates and fringe benefits can be contrasted with the states, productivity comparisons are difficult to make. For one reason, most Puerto Rico industrial groups have a higher ratio of production workers to total employees than in the States, because island manufacturing firms are production units rather than complete corporations. [The 1982 Census of Manufactures found that the value added per wage dollar in Puerto Rico was $8.16 compared to $4.03 in the United States].

Because U.S. labor laws currently apply in Puerto Rico, statehood would not alter significantly the difference between manufacturing wages in Puerto Rico and the 50 states. The Executive Director of Puerto Rico's Financial Council believes that by the year 2000, sections of the United States will be labor scarce while Puerto Rico with its expanding and young populace will continue to have a labor surplus. In his opinion this could serve to widen the gap between the U.S. and Puerto Rican average manufacturing wage and provide the island with a business location advantage.

Amended commonwealth proponents believe that the narrowing of the gap between the average hourly wage in Puerto Rico and the U.S. mainland is seriously hindering the island's ability to attract new industry. A major cause of this, they believe, is the movement to parity with the U.S. statutory-minimum wage. Hence, advocates believe Puerto Rico should be given the power to determine a flexible minimum wage for the island's workers and be granted authority to set other labor related policies.

Under independence U.S. labor laws would no longer apply in Puerto Rico. Puerto Rico could determine its own labor policies and minimum wage levels, but it would seem doubtful that an independent Puerto Rico would roll back its minimum wage levels to the extreme poverty level of those countries currently attracting low wage, labor-intensive industries. In addition, Puerto Rico as an independent republic could alter other labor policies to lower effective costs for business without changing wage rates.

Statehood Should Not Change Shipping Costs, but the Effect of an Amended Commonwealth or Independence is Speculative

Because Puerto Rico lacks the natural resources to supply industry and is far from mainland markets, transportation costs have been a disadvantage to businesses operating on the island. In addition, under existing Federal law, Puerto Rico must use U.S. ships for trade with the mainland. Some studies suggest these requirements result in higher shipping costs, but others contend that the use of foreign vessels would not lower costs.

Island economies are very dependent on shipping, and as much as 99 percent of Puerto Rico's external trade has been by ship. The island relies heavily on raw material imports from the states, and most finished goods are exported to the states. Transportation costs are therefore higher than for mainland locations which are closer to raw materials and markets.

Presently, U.S. shipping laws and trade regulations apply to Puerto Rico. Additionally, maritime trade between states, territories, and possessions—including Puerto Rico but not the Virgin Islands—must be carried on U.S. built, owned, and operated ships.

The 1979 *Economic Study of Puerto Rico* cited studies in 1965, 1969, and 1975 which showed that foreign vessel operating costs were 10 to 20 percent lower than

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[6] [In March 1985, the average total hourly compensation of wage plus benefits in manufacturing plants was $6.67 in Puerto Rico; $9.59 in Mississippi, the lowest cost state; and $13.11 in the United States as a whole]

U.S. vessels. A 1979 Harbridge Rouse, Inc., study estimated that it cost the Puerto Rico petrochemical industry more than $21 million annually to use U.S. rather than foreign ships. The *Economic Study of Puerto Rico* noted, however, that although open competition might temporarily lower rates of foreign shippers, some observers believe that in the long run these lower prices may not prevail. It also cited some disadvantages to open competition, including lost business to Navieras, the Puerto Rican government-owned shipping corporation and the largest carrier of U.S.-Puerto Rico trade; reduced employment of Puerto Rican crewmen on other U.S. ships; and less assurance of ship availability in a national emergency.

The relatively high cost of transportation would continue to be a disadvantage to firms operating in Puerto Rico, regardless of a status change. Statehood should not affect shipping costs because U.S. maritime laws and regulations already apply, but it has been suggested that Puerto Rico be served by U.S. vessels which receive subsidies similar to those received by vessels engaged in international trade. An independent Puerto Rico no longer would be required to use U.S. ships in its trade with the mainland and could establish its own maritime regulations and restrictions. The impact this could have on shipping costs and businesses depends on the policies adopted by the new nation. The impact of amended commonwealth also would hinge on future decisions, because advocates have suggested that Federal laws affecting shipping be studied to determine whether they be retained, modified, or eliminated.

Effects on Trade Arrangements Vary by Status Option

Puerto Rico is within the economic boundaries of the United States. Businesses export products to the states without tariffs and quotas or concern about fluctuations in foreign exchange rates. These factors give firms an advantage over those operating in foreign locations.

Puerto Rico depends on external trade, primarily with the States, for the bulk of its economic activity. Because changes in U.S. trade policies can have major effects on Puerto Rico's economy, the United States has solicited input from Puerto Rico during every round of trade negotiations since 1947. American trade policy is formulated primarily upon national interests, however, rather than regional or local concerns. As a result, changes in U.S. trade policies do not always benefit Puerto Rico.

Realizing the potential negative impact of trade policy changes on certain areas in the United States, the Congress enacted the Trade Act of 1974. This act provided for trade adjustment assistance for workers whose firms' production and sales were greatly affected by imports. The assistance consists of benefits such as cash allowances, counseling and placement services, training benefits, job-search expenses, and relocation assistance. Through March 31, 1979, 73 petitions for such assistance were filed by various Puerto Rico firms, and 52, affecting over 4,300 workers, had been approved.

Advocates of the three status positions believe that Puerto Rico's present influence on U.S. trade policies is not adequate to safeguard the island's interests. Amended commonwealth proponents believe that Puerto Rico must be granted greater power to act in this area, including the right to impose tariffs on goods arriving on the island and to enter into trade and other agreements with foreign countries. Statehood supporters believe that, as a state with a congressional delegation, Puerto Rico would be able to influence U.S. trade policies more effectively.

Independence proponents believe that an independent Puerto Rico could best protect the island's interests by setting its own trade policies and negotiating its own trade agreements. The PIP has advocated that a 10-year transition period be granted for gradually imposing U.S. tariffs at 10-percent increments on Puerto Rican products entering the states. This would allow Puerto Rico time to adjust to losing unrestricted trade with the mainland. The PIP also has proposed that companies already operating under a tax exemption grant be allowed duty-free access to mainland markets until the grant expires, but no longer than 10 years.

Businesses would retain unrestricted access to the U.S. mainland with either statehood or amended commonwealth. Under independence, however, businesses could expect to lose free access to U.S. markets and would have to consider foreign exchange fluctuations. In addition to its proposal for tariffs, the PIP also suggests a gradual transition for establishing a Puerto Rico monetary system.

The Effects of a Status Change on Capital Cost and Availability Differ

Puerto Rico's capital market is highly integrated with the U.S. market. Potential Puerto Rican investments compete for funds with other potential investments on the basis of risk and rate of return. Hence, credit worthy investments in Puerto Rico are financed as they are in the states.

Another facet of Puerto Rico's capital market is the availability of section 936 funds—the profits earned by U.S. tax-exempt firms which have not been reinvested or repatriated to the U.S. parent corporation. Conflicting evidence exists, however, on whether the cost and availability of credit have been significantly affected by section 936 funds. The Federal Treasury reported in June 1980 that the large inflow of financial assets of "936" corporations had a virtually imperceptible impact on net capital flows into Puerto Rico. Although there was a large inflow of 936 assets, there were offsetting flows out of Puerto Rico, mainly through the banking system. [According to the Federal Treasury, in fiscal year 1982, net capital inflows dropped by $2.5 billion in foreign direct investment possibly reflecting the large repatriations of 936 corporations in response to low financial returns in the first half of 1982.]

[At the end of 1983, of the $11 billion in financial instruments held by section 936 firms, about $10.6 billion were invested in Puerto Rico, as shown in table 9b.8.]

Table 9b.8—ESTIMATED COMPOSITION OF THE FINANCIAL INVESTMENTS OF POSSESSIONS CORPORATIONS AT YEAR-END 1983 [1]

[In billions of dollars]

Type of investment	Amount
Deposits in Puerto Rican banks	$6.0
Puerto Rico source Government National Mortgage Association mortgages	1.4
Loans to other section 936 possessions corporations	.4
Puerto Rican government bonds	.4
Repurchase-sale agreements not included in banks funds	.9
Mortgage and real estate loans	1.3
Other investments in Puerto Rico	.2
Total	10.6

[1] Some of the funds referred to as 936 deposits may include deposits by exempt firms which have not made a 936 election, e.g., local exempt firms; these however, are likely to be a small part of the total.

Most section 936 firms have avoided placing their funds in long-term investments such as Puerto Rico government bonds. As a result, most section 936 funds have been tied to short-term investments, including repurchase agreements or certificates of deposit issued by local banks. Although this helped the Puerto Rican government by providing capital for much of its short-term financing, it has not been a major factor in the long-term loans necessary to finance real investment, either by the public or private sectors.

Despite businesses' reluctance to invest section 936 funds in long-term instruments, Puerto Rico has not had problems floating bond issues. For example, a $300 million bond issue sold by the Government Development Bank in May 1980 was heavily oversubscribed. A major attraction of Puerto Rican bonds is the triple tax exemption which they enjoy because a bondholder residing in any of the 50 states pays no Federal, state, or local tax on income from Puerto Rican government securities.

In the event of statehood, section 936 would no longer apply to U.S. firms operating in Puerto Rico, and their profits would not necessarily be part of the island's capital market. Because of the island's integration with U.S. capital markets, however, the loss of these funds should have little effect on capital availability to business and government. As a result, statehood would not significantly affect the cost or availability of credit for businesses operating in Puerto Rico.

Statehood, however, likely would end the present arrangement where interest earned on Puerto Rican bonds is exempt fully from state and local income taxes in all 50 states in addition to Federal taxes. The effect statehood would have on bonds issued while the island was a commonwealth might need to be addressed during any deliberations over admission legislation. Although bonds issued after statehood would compete on an equal basis with those issued by other state and local governments, the extent of the influence that statehood's political permanence might exert on interest rates on Puerto Rican bonds would depend on the investment community's perception as to statehood's impact on the island's economic and political stability.

With independence, Puerto Rico's capital market would no longer be integrated with that of the United States, and bond issues would lose their current U.S. tax advantage. An independent Puerto Rico, however, would be able to establish its own monetary policy, apply for loans from sources such as the world Bank and International Monetary Fund, and seek foreign aid from the United States and other nations. The PIP has advocated that credit terms and guarantees extended to Puerto Rico by U.S. government agencies remain in effect until the original contractual terms expire and that the United States continue to recognize the Federal tax exemption for the island's public debt incurred under the control of American citizens and companies until its expiration.

American businesses operating in an independent Puerto Rico would still have access to the U.S. capital market, but changes in the investment community's perception of political and economic stability could affect capital availability and interest rates. Also, investors would have to consider foreign exchange fluctuations in decisions regarding Puerto Rican investments.

Amended commonwealth advocates believe that the island needs to be granted greater authority to seek external resources. For example, they believe Puerto Rico should be permitted to participate in international organizations and enter into financial, industrial, agricultural, technical, and other agreements with foreign countries.

Energy Costs Will Remain High Regardless of a Status Change

Puerto Rico relies almost exclusively on imported oil to supply its energy requirements. Lower cost oil imported from foreign sources gave Puerto Rico an important cost advantage in developing its petrochemical industry in the 1960s and early 1970s. Beginning in 1974, however, this situation has reversed as prices for domestic oil have remained below those for foreign oil.

Puerto Rico meets only a small fraction of its energy needs with its own resources, primarily hydroelectric power which supplies a small percent of the island's electricity. The rest of its energy needs are supplied almost entirely from petroleum-based products. Electricity has been more expensive in Puerto Rico than in the states.

Puerto Rico's electrical system is owned and operated by the commonwealth's Electric Power Authority. Because almost all of its electricity is generated by oil-fueled power plants, the cost of electricity soared along with the cost of oil. The average cost per kilowatt hour for industrial customers increased from $1.29 for the year 1971-72 to $4.55 for 1977-78. In the United States, average electrical costs per kilowatt hour in 1977 were about 70 percent of those in Puerto Rico. Further, because Puerto Rico is an island, its electrical system is not interconnected with other systems to help meet peak needs. This situation requires a higher reserve margin than is normal and contributes to higher energy costs. Puerto Rico has attempted to develop alternative sources of energy to reduce its use of oil. As is the case elsewhere, this has proven difficult. An attempt to build a nuclear power plant was postponed indefinitely, and efforts to derive energy from the sun, wind, and ocean are still in experimental stages. Other proposals to deal with the island's energy problem involve further development of hydropower, the use of sugar cane to produce a fuel such as gasohol, and the importation of coal.

Energy costs would be largely unaffected by a move to statehood, but statehood advocates contend a congressional delegation might be able to obtain increased Federal funding for energy development. An independent Puerto Rico would be able to negotiate oil purchase agreements with other countries. Similarly, amended commonwealth advocates have proposed that the island be granted the authority to enter into commercial agreements with foreign countries. Under any status, the island most likely would have to pay world prices for oil.

[This section has been selectively updated from the 1981 GAO report. Information contained in brackets has not been updated.]

SECTION 9C.—CULTURAL ENVIRONMENT

LANGUAGE: HISTORICAL PREDOMINANCE OF SPANISH, COURT PROCEEDINGS, STATEHOOD REQUIREMENTS

Puerto Rico's Culture is Distinct, and the Spanish Language Dominates

Puerto Ricans are extremely proud of their unique heritage, which stems from Spanish, Indian, African, and European/American cultures. This blend has resulted in a diverse and distinctly rich culture that has evolved gradually.

The Spanish had substantial influence while dominating Puerto Rico from 1493 until 1898. After the Spanish arrived, the island's original inhabitants, the Taino Indians, were forced into slavery. As the Indian population began to diminish, African slaves were imported to work the mines and sugar cane fields.

The Spanish also brought their language—a characteristic which has endured to the present day. Although Spanish and English are both official government languages, Spanish is more widely used in conducting government business and is the medium of educational instruction and daily communication throughout the island. Almost all newspapers as well as television and radio programs are in Spanish.

Since 1898 the United States also has influenced Puerto Rico's culture. Migration between Puerto Rico and the mainland has contributed to a cultural and social interchange. American influence has also been substantial in education, particularly in introducing English.

Language Policy historically has Fluctuated, but Efforts to Improve English Proficiency Continue

The number of Puerto Ricans who read; write, and speak English comfortably has increased considerably. Many are bilingual, and others can speak conversational English. However, in 1981 a majority were not considered officially bilingual. Puerto Ricans long have received English instruction, but its extent has varied greatly due to fluctuating policies. Examples of early policies follow:

—Between 1900 and 1905 Spanish was the medium of elementary level instruction, with English taught as a subject. In the secondary level English became the medium of instruction.

—Between 1905 and 1916 English became the medium of instruction in all grades, and reading in English was taught before children were instructed to read in Spanish.

—Between 1916 and 1934, Spanish was the medium of instruction in grades 1 through 4. Grade 5 was a transition year when half the subjects were taught in English and half in Spanish. Grades 6 through 11 were taught in English.

—In 1934 English continued as the medium of instruction in the secondary schools; however, Spanish was used throughout the elementary level. Also, time devoted to English in grades 7 and 8 doubled to 90 minutes.

Language policy fluctuations continued after President Roosevelt stated in 1937 that Puerto Rico should become bilingual. Following several changes, Spanish was established in 1942 as the medium of instruction for grades 1 through 6; junior high classes were conducted in English with some subjects taught in Spanish; and both English and Spanish were used in high school instruction.

Emphasizing English as the language of instruction created much controversy. This policy was dropped in 1948, and Puerto Rico was given total control of its education system. According to the 1966 status commission report, it was argued that the English requirement was pedagogically unsound, creating obstacles to education, and that the use of English rather than Spanish symbolized a colonial status."

Since 1948 Spanish has been the medium of public school instruction with English taught at all levels beginning in the first grade. Puerto Rico's formal English curriculum has two broad objectives: to develop a student's ability to understand, speak, read, and write English; and establish habits of using English to communicate.

Island educators believe that as U.S. citizens Puerto Ricans must have the opportunity to master English, the language through which many political and socioeconomic decisions are made affecting the island. Further, they believe English is important to all Puerto Ricans because it is the predominant international medium of communication.

Option for Conducting Federal Court Proceedings in Spanish is Advocated

Federal district court proceedings for the District of Puerto Rico have been in English since 1900. Although the U.S. House of Representatives approved a bill in 1980 to permit using Spanish in the court for a 12-year period, it was not passed by the Senate. This proposed legislation allowed initial pleadings to be in Spanish. Further pleadings and proceedings could be in Spanish when requested by a criminal defendant or upon agreement of all parties in civil cases. The bill also provided that individuals who can speak, understand, read, and write Spanish may serve on a grand or petit jury if the trial or proceeding is to be in Spanish.

Hearings on the proposed legislation disclosed that most defendants, parties, and witnesses, particularly in criminal cases, were primarily or solely Spanish-speaking. Also, because the ability to understand, read, write, and speak English adequately are prerequisites for grand and petit jury service, about half the population cannot serve as jurors. Further, judges, attorneys, and court personnel are primarily Spanish-speaking.

Proponents argued that because Spanish is part of Puerto Rico's cultural heritage and will continue as the dominant language, the bill offered a resolution to the U.S.

district court's unique problem. Opponents raised several concerns, including possible additional delay and expense in preparing records, as well as the need for additional personnel and facilities.

Four States Admitted Between 1812 and 1912 had Language Requirements Imposed

Although no constitutional provision prescribes an official U.S. language, English always has been the common tongue as well as the language of government and education. In the past, four states with large groups of non-English speaking residents had language conditions in Federal legislation enabling the state to be formed.

Admitted in 1812 as the nation's 18th state, Louisiana had both French and Spanish heritage. Louisiana's enabling act provided that:

> the laws which [Louisiana] may pass shall be promulgated, and its records of every description shall be preserved, and its judicial and legislative written proceedings conducted, in the language in which the laws and the judicial and legislative written proceedings of the United States are now published and conducted.

Similarly, Oklahoma's population contained a large number of American Indians when it became a state in 1907. Consequently, Oklahoma's enabling act provided that instruction in its public school system be conducted in English.

New Mexico and Arizona were admitted as states in 1912 with large numbers of Spanish-speaking residents. The enabling acts of both provided that school instruction be conducted and legislators be proficient in English.

New Mexico's constitution contained provisions protecting the rights of Spanish-speaking residents. It required that laws be issued in English and Spanish for 20 years after admission, teachers be trained in both languages, and children of Spanish descent never be denied a public education. All of these provisions are still in New Mexico's constitution.

MEASURES TO ACCOMMODATE LINGUISTIC MINORITIES

Recent Legislation Designed to Protect Rights of Linguistic Minorities

In recent years, greater attention has been focused on ensuring non-English speaking residents full participation in American life. Hispanics particularly are a large and growing U.S. minority. [In 1986 the Bureau of the Census estimated that Hispanics living in the 50 states and the District of Columbia numbered 18.1 million.] Some estimate that by the year 2000, Hispanics will overtake blacks as the largest minority.

Many Hispanic immigrants continue to speak Spanish after they arrive in the United States. A 1976 survey found that 80 percent of Hispanics live in households where Spanish is spoken and about one-third usually speak Spanish. Hispanics' view that their language is essential to maintaining cultural identity is reportedly part of a much broader movement of various U.S. ethnic groups to retain their native languages and traditions.

Federal legislation protecting the rights of linguistic minorities has been passed in several areas, including voting rights, education, and social services. Notwithstanding the controversy surrounding some of these measures, the basic intent has been to protect non-English speaking residents' rights. For example, the Bilingual Education Program of 1968 was established to meet the special educational needs of limited English-speaking children from low-income families. Also, the Voting Rights Act amendments of 1975 were designed to facilitate registration and voting by persons whose primary language is other than English.

Assisting non-English speaking Americans has extended to other federal activities. For example, the 1977 Food Stamp Act and regulations specify how and when bilingual materials and personnel must be used. Also, 1980 Census questionnaires were printed in Spanish for the first time.

Various Measures Used by Other Countries to Accommodate Different Language Groups

International attempts to recognize and protect linguistic groups have increased since the turn of the century. The League of Nations' Covenant provided some protection to linguistic minorities along with racial and religious minorities. Moreover, the United Nations charter consistently lists language along with race, sex, and religion as an impermissible ground of differentiation in the realization of human rights and fundamental freedom.

Nations composed of different language groups have employed various means to protect linguistic freedom and preclude discrimination. Although no universal rule exists, actions taken range from specific legal or constitutional guarantees to less formal arrangements. A 1976 Southern Illinois University Law Journal provided the following examples of how other countries have attempted to accommodate different language groups, but the relative success of these efforts can be gauged only by those involved:

—Legal equality of more than one national language for all practical and official purposes (Canada, Finland, and South Africa).
—Legal equality of all national languages, some of which are designated official (Switzerland and Belgium).
—Constitutionally protecting linguistic minorities, but the dominant national group's language is considered the official state language (Yugoslavia, Rumania, and China).
—Designating an official state language while recognizing auxiliary state languages (Ireland and the Philippines).

STATUS POSITIONS ON PUERTO RICO'S CULTURE

Widely Divergent Methods Proposed to Preserve Puerto Rico's Language and Culture

Maintaining and developing Puerto Rico's unique cultural identity is a vital concern of all political parties. Each, however, steadfastly advocates a different formula as the best solution.

Commonwealth advocates maintain that the island's culture and language have retained their indigenous characteristics despite [Puerto Rico's 91-year relationship with the United States.] Commonwealth supporters argue that a harmonious blend of American and Puerto Rican culture presently exists. They believe that the current arrangement has created unbreakable ties and an important mutually beneficial cultural interchange.

Commonwealth proponents also believe that U.S. citizenship is respected and honored but that Puerto Rico's identity stems from its distinct nationality. They believe that only an autonomous commonwealth can preserve and enhance Puerto Rico's culture and language while maintaining the protections inherent in its relationship with the United States.

Statehood advocates view admission as the culmination of Puerto Rico's political development and entirely consistent with America's multicultural composition. They point to the American system's openness and flexibility in admitting and protecting diverse ethnic and linguistic groups. Additionally, they maintain that Puerto Rico as a Spanish-speaking state can make significant contributions, particularly to relations with Latin America, in exchange for equal participation in the American system. Statehood advocates assert that their culture is too strong and resilient to disappear and that making the island an equal partner in sharing U.S. sovereignty would strengthen their culture and permit it to flourish. Attaining statehood, they believe, would make U.S. citizenship more meaningful and assure Puerto Ricans full and equal political rights.

Independence advocates believe that Puerto Rico has been prevented from preserving and adequately developing its cultural identity. They see a direct correlation between political autonomy and the ability to enhance their national identity. Asserting that Puerto Rico has had a vigorous capacity for resisting assimilation, they argue that the island is a well-defined homogeneous society with all the components of a national identity, except sovereignty.

Independence supporters believe that U.S. sovereignty and influence have been extremely detrimental to their culture and have been responsible for many social and economic problems. They believe independence is the peoples' inalienable right and the only way Puerto Rican culture can flourish without restraint.

[This section has been reprinted from the 1981 GAO report. It has not been updated.]

SECTION 9D.—INTERNATIONAL STATUS

PUERTO RICAN SOVEREIGNTY AND THE INTERNATIONAL COMMUNITY

Puerto Rico's Status Under Continuing Consideration by U.N. Committee, Despite U.S. Opposition

The United Nations, since its inception, has monitored the political evolution of non-self-governing territories. The U.S. voluntarily placed Puerto Rico in this category, and annual information on the island's political development was reported.

After the Commonwealth was established the United Nations removed Puerto Rico's non-self-governing designation in 1953 and announced that:

> . . . in the framework of their Constitution and of the compact agreed upon with the United States of America, the people of the Commonwealth of Puerto Rico have been vested with attributes of political sovereignty which clearly identify the status of self-government attained by the Puerto Rican people as that of an autonomous political entity.

This action, however, did not end United Nations consideration. Cuba attempted, but failed, to initiate discussion of Puerto Rico's status before the U.N. Decolonization Committee in the mid-1960s and before the General Assembly in 1971. In 1972, however, the committee discussed the island's status and adopted a resolution recognizing "the inalienable right of the people of Puerto Rico to self-determination and independence . . . ."

Since then, discussions have been held annually and other resolutions adopted by the committee. In 1978 and in 1979 the resolution also called for transferring all powers to the Puerto Rican people. This has been interpreted as a condition for changing their status. In 1980, the Committee again held hearings, reiterated its prior resolutions, and, in addition, urged the U.S. Government to present a plan for decolonizing Puerto Rico.

The U.S. Government, however, has stated that Puerto Rico should not be included by the United Nations in its consideration of non-self-governing territories. The United States maintains that self-determination has occurred and was recognized in 1953 when the U.N. General Assembly removed Puerto Rico from the non-self-governing list. Moreover, the U.S. has repeatedly affirmed its support for the "continuing right of the people of Puerto Rico to self-determination."

In its official statements, the United States also has said that it would not object to Puerto Rico inviting the United Nations or other appropriate international bodies to observe any status referendum. Further, in addition to reiterating its prior position, the United States in 1980 opposed the committee "recommending any actions that, if carried out, would tend to limit the political status options open to the people of Puerto Rico."

Although expressing different views, representatives from all major Puerto Rican political parties have testified at least once before the Decolonization Committee. In 1978, Governor Carlos Romero-Barcelo, a statehood advocate, testified that the Puerto Rican people have the means to change their political status; therefore, committee intervention is "neither necessary nor appropriate, and is totally unacceptable to the people of Puerto Rico."

Governor Rafael Hernandez-Colon, a commonwealth supporter, also testified in 1978. He stated that because the United States has not recognized the Puerto Rican people's will as expressed in the 1967 plebiscite, the United Nations has an important role. Governor Hernandez-Colon recommended that the U.N. General Assembly require the United States to recognize the Puerto Rican people's will to modify the terms of association, so that the Free Associated State will be brought to full self-government.

For many years, independence supporters, representing both the Puerto Rican Independence and Socialist parties, have actively participated in the Committee's hearings. They contend that Puerto Rico is a colony and the United Nations should force the U.S. Government to give the island its independence.

Status Positions Include Hypotheses of International Acceptance

Status participants advance different hypotheses about international acceptance of the three status alternatives. Like many other issues in the status debate, these hypotheses often are contradictory.

Statehood proponents argue that admitting Puerto Rico would evidence ethnic harmony and prove to the international community that the United States is not a colonialist power. They believe that a Spanish-speaking state would strengthen the U.S. image in Latin America by affirming that Hispanics are looked upon, not with disdain, but as equals.

On the other hand, opponents assert that statehood would precipitate widespread international opposition. According to them, Caribbean and Latin American countries would view statehood as forced annexation. In the view of one status participant, statehood "would certainly poison U.S.-Latin American relations for many decades."

Independence advocates believe that complete autonomy would be favorably accepted by the international community. They point to nonaligned nations' conferences which have endorsed Puerto Rican independence. For example, a September

1979 conference of nonaligned countries held in Cuba supported Puerto Rico's anticolonial struggle and asserted that the United States should transfer its powers so Puerto Ricans could freely determine their status.

Opponents assert that independence is not viable because it is not supported by most Puerto Ricans. Some believe that many Puerto Ricans would move to the U.S. mainland if the island became independent. A further contention is that many Latin American and Caribbean governments privately have reservations about an independent Puerto Rico because it could eliminate the stability which U.S. presence provides, but these countries do not publicly express this view because of nationalist sentiment.

Commonwealth advocates believe that the island's right of self-determination was exercised in 1952 when the commonwealth was established. They believe, however, that the current arrangement must be amended to bring full self-government. On the other hand, it has been contended that commonwealth in any form only would perpetuate international criticisms of the island's status.

Status Proposals Offer Puerto Rico Varying Positions in the International Community

The U.S. Government represents Puerto Rico in international government organizations and negotiations. In this regard, Puerto Rico is treated like states, which the U.S. Constitution precludes from making agreements with another state or foreign power.

The island, however, has shown some interest in joining certain international groups. In one such instance, a congressional committee report noted that congressional authorization was necessary before Puerto Rico could join the Caribbean Development Bank. The report cited the U.S. constitutional provisions prohibiting states' involvement in foreign affairs and granting the Congress power to "dispose of and make all needful Rules and Regulations respecting" territories. Although a few hypothesize that these provisions do not apply because of the island's commonwealth status, the United States traditionally has represented Puerto Rico.

This situation would not change should Puerto Rico attain statehood. Although admission would eliminate contentions regarding the inapplicability of the constitutional provision precluding state involvement in foreign affairs, questions have arisen regarding the island's continued separate participation in certain events such as sports contests. A U.S. State Department official commented that because organizations sponsoring such events are not typically official government bodies, continued separate Puerto Rican participation depends on the organizations' rules and decisions.

Independence would clearly enable Puerto Rican participation in international forums as a separate government. Additionally, Puerto Rico would be eligible for foreign assistance from the United States, other nations, and international agencies. With independence would also come the responsibility of negotiating treaties and agreements with the United States and other countries, foreign businesses, and international organizations. Treaties in many important areas, such as trade and defense, would be vital to the new republic's economic development and security.

Amended commonwealth proponents advocate granting Puerto Rico certain rights in foreign affairs. For example, the 1975 proposed Compact of Permanent Union included the following provision:

> The United States will have responsibility for and authority with respect to international relations and defense affecting the Free Associated State of Puerto Rico. The Free Associated State may participate in international organizations and make educational, cultural, health, sporting, professional, industrial, agricultural, financial, commercial, scientific, or technical agreements with other countries consistent with the functions of the United States, as determined by the President of the United States and the Governor of the Free Associated State on a case-by-case basis.

Another provision proposed granting the island observer status with U.S. trade negotiating delegations and consulting Puerto Rico on positions and decisions. The compact also proposed that the United States, upon request and agreement of Puerto Rico, seek to have the island designated eligible for regional or worldwide preferences available to developing countries.

STRATEGIC DEFENSE

Status Debate May Include Strategic Defense Concerns

Since 1898 Puerto Rico has afforded the United States a secure position for protecting U.S. interests and training military personnel. In addition, Puerto Ricans have served in the U.S. Armed Forces since 1917. In return, the island has received protection and certain economic advantages from this common defense relationship.

This relationship, however, has prompted controversy. Independence advocates long have condemned the U.S. military presence. Additionally, many residents have opposed the use of Puerto Rico's offshore islands, Culebra and Vieques, for military exercises. Training on Culebra has ceased, but the continued use of Vieques has drawn protest from all political parties.

All U.S. Armed Force branches operate to some extent in Puerto Rico, but the Navy uses the island most extensively. U.S. Naval Station Roosevelt Roads, on Puerto Rico's eastern coast, is the United States' largest naval base. In congressional testimony, high-ranking Naval personnel have described the Puerto Rico operating region as the world's best naval training area. Without Puerto Rico, they state, the Atlantic fleet would be unprepared to defend U.S. interests and support American allies. In addition to affording a major training facility for the U.S. Navy and allied forces, Roosevelt Roads provides a strategic U.S. presence.

Although U.S. military bases in the Caribbean were greatly reduced after World War II, Puerto Rico is still considered strategically important. The island's central location is considered valuable as a communications and control center as well as an intermediate staging area for military operation elsewhere. Also, the island provides the potential for expanded military operations if necessary, and it affirms American presence in the Caribbean—a region considered vitally important to the United States.

U.S interests in the Caribbean have been described as including significant domestic and security concerns. Protecting U.S. citizens and property as well as maritime boundaries and fisheries and controlling illegal immigration and narcotics are mentioned as domestic considerations. Security concerns arise because much of the United States' petroleum supplies and other strategic materials, such as bauxite, travel sea routes frown the Panama Canal and South America.

Recent events have focused more attention on the Caribbean's strategic importance. Although many Caribbean islands are still politically associated with larger nations, including the United Kingdom, France, the Netherlands, and the United States, several have recently achieved independence. In contrast to 1959, when only 3 independent islands existed, there were 11 in 1979 with others expected to be independent.

While affirming these islands' sovereignty, this trend has also raised concerns about the region's political and economic stability. In late 1979 testimony before a House Subcommittee, a U.S. Deputy Assistant Secretary of State described the region as "an area of endemic weakness and potentially serious instability." He also stated that most islands are too small in size and population to be economically viable and even the larger islands were suffering. Another complicating factor is that because the Caribbean is composed of many islands with different languages and cultures, it lacks regional unity. Further, Cuba, the Caribbean's largest and most populous country, reportedly has been moving to strengthen its regional role.

The Caribbean's posture and Puerto Rico's defense relationship with the United States may be factors during status deliberations, but discussion would vary depending on the status option. Statehood would guarantee U.S. presence, and amended commonwealth also would most likely continue the present arrangement. Should independence be chosen, however, provisions regarding U.S. military operations would have to be negotiated between Puerto Rico and the U.S. Government.

[This section is new and was not contained in the 1981 GAO report.]

SECTION 10.—SELECTED BIBLIOGRAPHY

We developed a selected bibliography based on a variety of sources. Following is a synopsis of several books and reports as well as listings of publications prepared by others.

SELECTED ANNOTATED BIBLIOGRAPHY

Carr, Raymond. Puerto Rico: A Colonial Experiment. New York: Vintage Books, 1984.

> Raymond Carr presents a historical discussion of the relations between the United States and Puerto Rico. It begins with a description of the colonial period and the evolution of Puerto Rico's present relationship with the United States. Subsequent sections deal with contemporary issues, such as

the Puerto Rican political parties and a status referendum. The last chapter treats events and issues between the election campaign of 1980 and mid-1982. This last chapter illustrates attitudes during an uneasy period in the relationship between the United States and Puerto Rico. In part, this chapter is concerned with the party politicians' behavior in Puerto Rico and also with the way that these politicians and the establishment in general perceived the impact of changes in national policies under the Reagan administration upon the well-being of the island.

Curet Cuevas, Eliezer. Puerto Rico: Development by Integration to the U.S. Rio Piedras, Puerto Rico: Editorial Cultural, 1986.

This study explains (1) the economic development of Puerto Rico, (2) the nature and causal relations of the rapid rate of economic growth experienced from 1950 to 1974, and (3) the slowdown that has been observed since then. It examines the factors that have shaped that growth to test the hypothesis that the results were determined by the nature of the development strategy: (1) the industrial specialization for export markets, (2) the reliance on external sources for capital, technology, raw materials, and energy, and (3) the integration with the U.S. economy with respect to financial, labor, and goods markets. It describes the testing of the hypothesis by using an econometric model. This model disclosed other factors that are important determinants of economic growth patterns, such as: (1) the inputs of labor and capital, (2) tax exemption, (3) the government fiscal and economic policies, (4) demographic changes, and (5) the value of imported oil.

The author discusses the events since 1973, which have been interpreted to represent a very low net long-term growth trend. It was argued that these trends cannot be reversed without substantial changes in the economic and political structure. The author concludes that political stability and generally sound economic policies and management in Puerto Rico up to 1968 contributed effectively to economic growth. On the other hand, he concludes that political instability and mismanagement of the economy since then have been an important determinant of Puerto Rico's economic stagnation.

Dietz, James L. *Economic History of Puerto Rico: Institutional Change and Capitalist Development*. Princeton: Princeton University Press, 1986.

James Dietz contributes to interpretations of Puerto Rico's political economic history. In particular, it examines the evolution of the island's industrialization strategy from the early 1950s to the mid-1980s. The author discusses Puerto Rico's rapid economic growth as a result of Operation Bootstrap, which was designed to attract capital-intensive industries through tax exemption. In addition, the author describes how employment generation, the expansion of public debt to finance social welfare programs, and unimpeded migration of surplus workers to the mainland contributed to Puerto Rico's economic history.

Morales Carrion, Arturo. *Puerto Rico: A Political and Cultural History*. New York: W. W. Norton and Company, Inc., 1983.

This book discusses the social, political and cultural factors that have shaped Puerto Rico and given it a distinctive character. A prime consideration of this book is to establish a more balanced perspective of the United States' relationship with the island and of what Puerto Rico constitutes as a people (its Spanish heritage) and as a separate and distinct Caribbean entity. This book is divided into three parts. The first deals with the formative centuries, the arrival of Spanish civilization, and the Puerto Rican struggle for self-determination. The second deals with the twentieth century—colonial or dependent relationship with the United States and the evolution of Puerto Rico's cultural profile, including literary and artistic traditions. And the third deals entirely with Puerto Rico's cultural expression, its folk traditions, its art and literature from its Indian heritage to the present.

Puerto Rico Federal Affairs Administration. *Documents on the Constitutional Relationship of Puerto Rico and the United States*, edited by Marcos Ramirez Lavandero, Washington, D.C., 1988.

These documents are an updated compilation of the historical judicial decisions and legislative changes on Puerto Rico's Constitutional development and its relationship with the United States. Bibliographies of books and articles, Supreme Court cases, and some First Circuit Court cases related to Puerto Rico are included. This reference book provides information on the leading cases that deal with the legal implications of the Commonwealth status and the territorial status of Puerto Rico. In addition, it contains a section on the amendments to the Federal Relations Act and documents related to proposed modifications or clarifications of Commonwealth status. It also contains United Nations documents on Puerto Rico as well.

Thomas, Arnold Norman. *Associated Statehood in the Leeward and Windward Islands: A Phase in the Transition to Independence (1967–1983).* New York: City University of New York, 1987.

Arnold Norman Thomas applies the principle of self-determination to the Caribbean mini-states of Antigua, St. Kitts-Nevis-Anguilla, Dominica, Grenada, St. Lucia, and St. Vincent. The smaller islands, following independence of the larger West Indian territories, were not considered to be economically viable for independence. The mini-state dilemma was solved through the constitutional device of "associated statehood," which provided the islands with full control over internal affairs while the United Kingdom retained responsibility for defense and external affairs.

As a phase in the transition to independence, associated statehood was also regarded as a strategy for creating the conditions prerequisite to independence.

There are six main themes: (1) the role of the international system in determining the status of territories, (2) plans to devise schemes for the decolonization of the West Indies, (3) the status of associated statehood in the international system, (4) the debate over economic viability, (5) associated statehood as a transitional phenomenon, and (6) the place of small states within international systems.

The study is divided into four parts. The first part provides a background to the choice of associated statehood. The second part, analyzes the experience of statehood in the Caribbean (1967–83). The third part lays out the debate on economic viability in the transition to independence for these islands. And the fourth part assesses the place of small states within the international system.

Several conclusions are offered on the statehood phenomenon:

—The associated statehood was designed more to slow down the pace of decolonization at a time when the United Kingdom was hard-pressed in the United Nations, and less over the presumed economic non-viability of the associated states.

—The associated statehood failed to create economic viability but provided the islands with experience in international affairs through participation as members of the Caribbean Community and Common Market.

—The transition to independence was not based on presumed economic viability but on the more pragmatic premise that independent status offered more opportunities and greater access to international aid.

—The islands' small size and economic viability are no longer impediments to independence because the criteria for viability had been eroded within a short space of time.

U.S. General Accounting Office. *Experiences of Past Territories Can Assist Puerto Rico Status Deliberations. GGD-80-26.* Washington, D.C.: March 7, 1980.

Procedures and terms established by the Congress in admitting states and granting independence are historically analyzed. Historically, the Congress has been guided by tradition, but it has also been adaptable when considering and legislating changes to the status of territories. The Congress' broad authority and the diversity of each applicant have produced some patterns and many variations in admitting the 37 states beyond the original 13 and granting independence to the Philippines.

U.S. General Accounting Office. *The Challenge of Enhancing Micronesian Self-Sufficiency. ID-83-1.* Washington, D.C.: January 25, 1983.

Our report discusses the problems that the governments of Palau, Micronesia, and the Marshall Islands face in becoming more self-sufficient and the substantial technical assistance these governments need to enhance their capabilities to overcome these problems.

We found that their economies are dependent upon the transfer of U.S. funds. Geographic, social, and public policy constraints and other factors limit the growth of private-sector economy. Resources to meet increasing demands on health and education services are limited. Micronesia is experiencing public administration problems In financial and personnel management and human resource development.

Because the United States will have a continuing interest in the long-term development of Micronesia, we made recommendations to the Secretary of the Interior to help accomplish this objective, such as conducting assessments of technical assistance requirements of the Micronesian governments and developing an action plan to guide the provision of all United States and other technical assistance to the governments.

U.S. General Accounting Office. *Issues Affecting U.S. Territory and Insular Policy.* GAO/NSIAD-85-44. Washington, D.C.: February 7, 1985.

Information and views are provided on the current state of affairs in federal-territorial relations in terms of federal policies, laws, programs, and organization.

We found the issues involving federal-territorial relations, such as appropriate levels of representation, treatment under federal laws and programs, and economic and social development strategies, are becoming increasingly complex with no simple solutions. We believe these issues are likely to require greater congressional attention and to stimulate debate on whether further policy guidance is needed to clarify and strengthen federal-territorial relations. Many territorial leaders support the concept of a high-level, interagency group to handle policy-related matters and address major territorial concerns.

U.S. General Accounting Office. *U.S. Territory and Insular Policy.* Statement of Joseph E. Kelley, Associate Director, National Security and International Affairs Division. Washington, D.C.: April 10, 1986.

We testified on several aspects of U.S.-territorial relations, specifically: (1) the background and history of U.S. territorial policy, (2) the extent to which U.S. foreign and domestic policies consider the potential impact on the territories, and (3) whether federal policies are meeting U.S. policy objectives and territorial needs.

We found that: (1) while some of the territories are currently reexamining their relationship with the United States, the federal government has adopted a flexible approach in dealing with the political aspirations of territorial inhabitants, and, as a result, each territory has freely chosen different types of political status based on its unique characteristics and needs; (2) although the United States has consistently encouraged economic independence in the territories and has provided financial and technical assistance amounting to millions of dollars, most of the territories have made limited progress toward economic self-reliance; and (3) significant increases in economic self-reliance remain unlikely in the foreseeable future because many indigenous constraints limit access to outside investment.

U.S. General Accounting Office. *Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and American Samoa.* GAO/HRD-87-60. Washington, D.C.: September 15, 1987.

Our report analyzes the potential effects of fully extending Supplemental Security Income (SSI), Aid to Families with Dependent Children (AFDC), Medicaid, foster care, Child Support Enforcement, and Food Stamp benefits, and federal income taxes, to Puerto Rico, the Virgin Islands, Guam, and American Samoa for 1984.

We found that, for Puerto Rico: (1) federal costs would more than double—increasing an estimated $1 billion—due to higher benefits, more recipients, and greater cost-sharing; (2) the Commonwealth's share of program costs would decrease about 38 percent; and (3) federal tax revenues would have increased in the short term by an estimated $2.4 billion, but might decrease over time because of lost business tax incentives. Puerto Rican officials generally supported extending most program benefits, but opposed extending federal income taxes.

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PREPARED STATEMENT OF JAMES M. MURPHY, JR.

We appreciate this opportunity to provide comments to this Committee on S. 712, legislation to offer a referendum on the future political status of Puerto Rico.

We have examined closely the three options contained in the bill to identify implications for U.S. trade policy. We do not comment on the overall merits of any of the particular options.

We had the opportunity of expressing our views on S. 712 before the Senate Committee on Energy and Natural Resources on July, 13, 1989, and of submitting a statement on a draft dated July 21, 1989 (6:30 p.m.). The current version of the bill satisfactorily addresses most of the concerns we indicated in those statements.

The only major remaining difficulty from a trade policy perspective is the treatment of coffee. In addition, we have suggestions on a few other trade-related provisions of the bill.

TITLE II—STATEHOOD OPTION

Tariff on Coffee

Since 1930, Puerto Rico has been allowed to maintain its own tariff regime on coffee, despite the fact that Puerto Rico is in the Customs territory of the United States. Using this special Congressionally provided authority, Puerto Rico charges a duty on all coffee imports (currently at $1.40 per pound) including those from the United States. The U.S. tariff on coffee is zero, a rate which is bound under the rules of the General Agreement on Tariffs and Trade. The Puerto Rico Coffee Board reported that duties collected on coffee imports into Puerto Rico in 1988 totalled nearly $11.1 million.

The language in subparagraph (e)(1) of section 213 is ambiguous concerning Puerto Rico's ability to impose a tariff on coffee after Statehood. USTR requests that Congress make an explicit determination on this issue. We believe that Puerto Rico should not be permitted to impose a tariff on coffee.

We recognize that Puerto Rico's ability to levy a tariff on interstate shipments of coffee is an issue for Congress to decide. However, *strictly as a policy issue*, we believe that permitting a State to levy its own tariffs, even if limited to imports from other States, is highly undesirable and sets an unfortunate precedent. We know of no other State that levies its own tariff on interstate commerce. In this respect, allowing Puerto Rico to continue imposing a tariff on coffee would appear to be contrary to the intent of section 201, lines 18-19, that Puerto Rico "shall be declared admitted into the Union on an equal footing with the other States."

Having a tariff only on imports of coffee from foreign sources would be useless in protecting the Puerto Rican industry. Coffee would be transshipped duty-free from the other fifty States into Puerto Rico.

If it is decided that the coffee tariff ought to be retained in some form, we could support keeping it only for an *appropriate transitional period*, during which it would be phased down to zero, the level of the U.S. tariff on coffee. Indeed, as a policy matter, we do not believe that Puerto Rico should be permitted to continue to levy a tariff even under Commonwealth status.

International Coffee Agreement

Although Puerto Rico is part of the U.S. Customs territory for other purposes, it has been exempt from the requirements of the International Coffee Agreement (ICA) As a result, even when the ICA's export quota provisions were in effect, Puerto Rico was allowed to import coffee from countries which are not members of the ICA. If this situation were to continue after Statehood, it would seriously undermine our ability to implement the import control provisions, which are required under the ICA when the Agreement's export quotas are in effect.

Recommended Changes

We strongly recommend that the bill be appropriately revised to reflect the following points:

- that Congress should preferably eliminate or at least phase-out the tariff on coffee, under either Statehood or Commonwealth status; and
- that Puerto Rico, if a State, will be bound by the requirements of the International Coffee Agreement, as they apply to the United States generally, at the time it is admitted to the Union.

TITLE III—INDEPENDENCE

Free Trade Agreement

Section 316(b) indicates a procedure for developing specific provisions governing trade between the United States and an independent Puerto Rico. In this section, Congress expresses its willingness to consider a mutual free trade agreement.

The Administration has not made any decision on the issue of negotiating a free trade agreement with an independent Puerto Rico. However, we have some suggestions regarding the procedure that should be specified in the bill.

If the Task Force on Trade, established by the Joint Transition Commission, favors the negotiation of a free trade agreement, its recommendations should be forwarded to the Senate Finance Committee, the House Ways and Means Committee and the United States Trade Representative for appropriate consideration and action. Furthermore, since the President's authority to negotiate a free trade agreement under section 1102(c) of the Omnibus Trade and Competitiveness Act of 1988 expires as of June 1, 1993, Congress may want to specify a longer time frame in this bill for consideration of such an agreement with Puerto Rico.

Caribbean Basin Economic Recovery Act (CBERA)

Section 316 (b) seems to require the President to designate Puerto Rico as a beneficiary under the CBERA if it meets all criteria and requirements.

We believe the bill should be clarified so that the President is given the authority to designate Puerto Rico as a beneficiary under the CBERA, rather than being required to do so, provided that Puerto Rico is found to meet all criteria for eligibility. This would be consistent with current provisions on designation of CBI beneficiaries. Also, section 212(b) of the CBERA should be amended to include "Puerto Rico" in the list of countries that the President shall consider as beneficiary countries.

Mr. Chairman, this concludes my comments on S. 712. We appreciate the opportunity to express our views.

PREPARED STATEMENT OF WILLIAM OCASIO

Mr. Chairman, distinguished members of the Senate Finance Committee. It is indeed an honor and a privilege to be here today to testify as an economist representing the Commonwealth on the Federal social welfare programs both under existing Commonwealth status and under proposed changes under S. 712.

Puerto Rico currently participates in several federal welfare programs under the jurisdiction of the Senate Finance Committee. These include full participation in Social Security, Medicare and unemployment insurance, partial participation in Medicaid, Aid to Families With Dependent Children (AFDC), and special participation in Aid to the Aged, Blind and Disabled (AABD) in substitution for SSI programs. Puerto Rico currently receives approximately $3.3 billion a year for these programs. At the same time, Puerto Rico contributes approximately $1.6 billion to the U.S. Treasury in Social Security payroll taxes, Medicare and unemployment insurance.

The people of Puerto Rico will vote in 1991 on a referendum that will determine the Course of our future political relationship with the United States. S. 712 is designed to clearly specify the conditions under which the United States would abide with the choice of the majority of the Puerto Rican people between the three status alternatives: enhanced Commonwealth, Statehood or Independence.

The Senate Energy and Natural Resources Committee established three policy objectives for the design of the tax and welfare provisions: (1) revenue neutrality (2) a "level playing field" (3) smooth transition period.

Unfortunately S. 712, as reported out of Committee, fails to meet these objectives. As Governor Rafael Hernandez Colon testified yesterday, the legislation front-loads the welfare benefits of statehood in 1992 while postponing the costs to the population from imposition of Federal personal and corporate income taxes and phasing-out until 1997 the repeal of Section 936. This imbalance must be redressed.

The failure of S. 712 to meet its stated policy objectives is based, at least in part, on incorrect assumptions used by the Energy and Natural Resource Committee on the revenues to be gained from gradual imposition of all Federal taxes in Puerto Rico under statehood, as discussed yesterday, and on the costs of additional welfare expenditures, which we will discuss today. The Energy Committee's estimates of welfare costs were based on testimony presented by the Department of Agriculture and Health and Human Services. However, as has been demonstrated by the Congressional Budget Office, the Administration's cost estimates were severely flawed.

The Congressional Budget Office has produced a more reasonable, albeit static analysis of the costs of full imposition of welfare programs to Puerto Rico under statehood. CBO's estimates differ from the Energy Committee's estimates primarily in the case of Food Stamps and Medicaid. The earned income credit is also evaluated, which was apparently excluded from the Energy Committee's analysis.

In the case of food stamps, CBO estimates the additional costs of full imposition of food stamps at $700 million, with an additional 300,000 participants. Puerto Rico currently has both lower benefit levels, resulting in average monthly payments of $52 per person, compared with $77 in the U.S., and lower cutoffs for eligible income levels for each family size. The CBO cost estimates for Food Stamps are consistent with static simulations undertaken with data obtained from the Puerto Rico Commonwealth Department of Social Services.

CBO estimates the Federal costs of Medicaid to be $900 million in 1992, compared with the Energy Committee's assumption of only $55 million using Administration data. CBO assumes 1.35 million eligible Medicaid recipients with an average cost of approximately $800 per person in 1992, of which the Federal share could be $667. This compares with a U.S. average of total costs of $2,310 in 1988, which escalated at 6 percent per year yields $2,916 in 1992. The state with lowest Medicaid costs, Mississippi, had an average per recipient of $1,133 in 1988, or $1,325 in 1992.

Full imposition of Medicaid to Puerto Rico would transform health and hospital care from a low-cost system where the Commonwealth provides all Medicaid-funded services to a system of free provider choice between public and private service provisions and significantly higher costs. While CBO's assumption that the average costs in Puerto Rico would be about 70 percent of the lowest state appears plausible, the assumption of an eligible population of 1.35 million may be low. Currently the Commonwealth Health Department certifies 1.6 million persons in Puerto Rico as medically indigent, or approximately half of the population. The Department estimates the actual indigent population to be closer to 2.2 million. If we use the 1.6 million figure, total Medicaid costs would be 1.28 billion, with a federal cost share of 1.062 billion in 1992.

With respect to Aid to Families With Dependent Children (AFDC), CBO estimates that statehood for Puerto Rico would have a relatively small effect on Federal outlays. This is based on the assumption that Puerto Rico would, as a policy decision, not raise its AFDC payment standards. Currently Puerto Rico's maximum AFDC benefits for a three-person family is $90 per month, which is $28 below the lowest maximum payment in the fifty states (Alabama). The average payment among families of all sizes in FY 1988 was $101 per month in Puerto Rico, compared with $370 among the states. Puerto Rico would have strong financial incentives to increase its AFDC payment levels. Under Commonwealth, Federal cost-shares are capped and three Federal dollars are received for every dollar from the Puerto Rican government. Under statehood, $4.88 Federal dollars are received per each Commonwealth dollar, an increase of 63 percent. If the Puerto Rican government would invest only one-third (or $89 million) of CBO's estimates of the Puerto Rican government savings on Medicaid expenditures in expanded AFDC coverage, the additional Federal costs of AFDC would be $433 million, bringing Puerto Rico up to par with average Federal AFDC payment levels.

Our discussion of increased Federal outlays has been based so far on a static analysis of the costs of federal outlays. While static analysis may be an adequate first approximation for revenue estimation in some instances, it is wholly inaccurate in the case of S. 712. The statehood alternative would, with the phase-out of Section 936, completely alter the foundations of Puerto Rico's industrial and economic development, would substantially increase unemployment, and would decrease wages and compensation levels. The resulting changes in Puerto Rico's economy would greatly increase eligibility for Federal social welfare programs and would further increase their costs.

We believe that CBO estimated Federal Outlays under Statehood of $3.25 billion in 1995 are low. They are low both because the additional costs of AFDC are underestimated and because no dynamic analysis of the behavioral impacts of statehood was undertaken. The phase-out of Section 936, the cornerstone of our industrial and economic development will bring substantial loss of jobs to Puerto Rico.

The substantial economic dislocation under statehood is acknowledged even by the conservative relocation estimates provided yesterday by the Treasury Department. These account for a loss of 25 percent of tax revenues due to foreign relocation, and imply an even greater relocation of jobs to both the United States and foreign locations. If Puerto Rico were to lose at least one-third of its manufacturing employment, or 57,000 jobs, as implied by Treasury's testimony, and assuming an indirect multiplier of one, this results in a net loss of 114,000 jobs, over 12 percent of total employment on the Island.

Moreover, neither the Administration nor the statehood proponents have articulated a coherent alternative of economic development under statehood. No explanation has been given of how phase-out provisions would do anything but partially delay the deleterious impacts of repeal of Section 936. Increased unemployment and poverty will increase participation in and the costs of Food Stamps, Medicaid, AFDC, Earned Income Credit, and eventually SSI. To give but one example, an additional 114,000 unemployed heads of household with an average family size of three implies additional Food Stamps costs of $316 million dollars, over and above CBO's static outlay numbers. We are currently undertaking a more complete dynamic evaluation of these costs with the assistance of KPMG Peat Marwick.

It is my professional judgment, however, that the additional Federal outlays under statehood would easily exceed $4 billion by 1995, compared with the $3.25 billion estimated by CBO. This implies that under any reasonable assumptions regarding increased revenues, statehood would bring about substantial sustained costs to the U.S. Treasury in perpetuity, at the same time it brings increased unemployment and decreased earnings in Puerto Rico. Statehood would clearly not be revenue neutral at the same time it is harmful to the Puerto Rican economy.

The Senate Finance Committee faces some very difficult choices in its consideration of S. 712 and in providing Puerto Rico with our democratic right to self-determination between the three status alternatives. The policy decisions must be made, however, with a recognition, as accurate as possible, of the economic impacts of the status alternatives. This must by necessity include a full dynamic analysis of both revenues and costs. It is essential that CBO estimates of Federal outlays be revised to fully account for these dynamic effects.

Thank you very much.

PREPARED STATEMENT OF SHIRLEY D. PETERSON

Mr. Chairman and Members of the Committee: It is an honor to appear before you today on behalf of the Department of Justice to discuss Senate Bill 712, a bill "To Provide for a Referendum on the Political Status of Puerto Rico." As the Assistant Secretary of the Treasury for Tax Policy has testified this morning, the Administration strongly supports this bill, which would permit the people of Puerto Rico to determine the future political status of their island. I am pleased to provide the Committee with the Justice Department's views on the economic adjustment provisions of Senate Bill 712.

I am here today to testify as to the constitutionality of the economic adjustment provisions in the statehood portion of the bill. We believe that those provisions would meet the requirements of the Constitution and would likely be upheld by the courts. As I will discuss shortly, however, the ultimate resolution of that question hinges, in part, on Congressional findings regarding the type and magnitude of economic dislocation that would be occasioned by Puerto Rico's transition into statehood.

My testimony will focus primarily on two provisions in the statehood portion of the bill: first, the provision in section 213(d) of the bill, which would phase out the section 936 tax credit; and second, the provision in section 213(e) of the bill, which would provide for the covering over of certain Federal tax revenues into the Puerto Rican Treasury.

I am here today to discuss only the constitutional issues presented by the economic adjustment provisions of S. 712.[1] We, of course, defer to the Treasury Department's views regarding the tax policy and technical aspects of the bill.

I. PHASE-OUT OF SECTION 936 BENEFITS

Section 936 of the Internal Revenue Code currently provides qualifying corporations with an election to take a tax credit equal to the portion of the corporations' United States tax attributable to (i) the active conduct of a trade or business in a U.S. possession or the sale or exchange of substantially all the assets used in such trade or business, and (ii) certain possession-sourced investments. Sec. 936(a). For purposes of this credit, the term "possession of the United States" is specifically defined to include Puerto Rico. Sec. 936(d). The effect of the credit is thus to exempt from U.S. taxation certain income attributable to Puerto Rican business and investments.

Under section 213(d) of the bill, the Federal internal revenue laws would apply to Puerto Rico effective January 1, 1994, if it became a state. As a proviso to this effective date, Section 213(d) further states that the credit under Code section 936 would be phased out ratably over four years. Under the bill, then, the section 936 credit would be continued for approximately 6 years after Puerto Rico became a state: the current credit would remain fully intact from the date of statehood proclamation through 1993; and the credit would apply as specified by the phase-out provision from 1994 through 1997.

The proposed extension of Section 936 benefits to Puerto Rico after it becomes a state raises a constitutional question under the Tax Uniformity Clause. Article I, Section 8, Clause 1, of the Constitution provides that:

> The Congress shall have the Power To lay and collect Taxes, Duties, Imposts and Excises to pay the Debts and provide for the common Defense and general Welfare of the United States; *but all Duties, Imposts and Excises shall be uniform throughout the United States*. [Emphasis added.]

The Tax Uniformity Clause was one of several measures introduced at the Constitutional Convention to limit the National Government's authority to wield its power over commerce and taxation to the disadvantage of particular States. As stated by Justice Story in his *Commentaries on the Constitution of the United States* § 957 (T. Cooley ed. 1873), the purpose of the Tax Uniformity Clause "was to cut off all undue preferences of one State over another in the regulation of subjects affecting their common interests" and to prevent "oppressive" combinations of states from exercising their taxing powers to strike at the "vital interests" of one region. The exercise of the taxing power by a Congress composed of representatives of fifty states to grant temporary tax benefits to the fifty-first state entering the Union hardly qualifies as the oppression which the Tax Uniformity Clause was designed to prevent. Indeed, there is no evidence that the Framers intended the Clause to so constrain the exercise of Congress' power under Article IV to admit new states to the Union as to disable Congress from fashioning reasonable and necessary transitional arrangements.

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[1] The Justice Department has other technical, legal and constitutional concerns with certain provisions of S. 712 that will be presented to the appropriate committee at the proper time.

Thus, we believe that the proposed phase-out of the section 936 credit would not create an "undue preference" for Puerto Rico and would not be found to violate the Tax Uniformity Clause. The courts have not extensively dealt with the various uniformity clauses in the Constitution, and the precise boundaries of Congressional authority are not clearly defined. However, in the two most recent cases thoroughly considering the uniformity provisions of the Constitution, *United States* v. *Ptasynski*, 462 U.S. 74 (1983) and the *Regional Rail Reorganization Cases*, 419 U.S. 102 (1974), the Supreme Court held that classifications framed in geographical terms could, in certain circumstances, survive challenge under the uniformity clauses. Thus, in *Ptasynski*, the Court found constitutional a statutory exclusion from the Crude Oil Windfall Profits Tax Act of 1980 of oil drawn from geographically defined areas that included portions of Alaska. The Court held that Congress could frame tax legislation in geographic terms in response to a geographically isolated problem. It concluded that Congress had not sought to benefit Alaska for reasons "that would offend the purpose of the Clause," such as "intend[ing] to grant Alaska an undue preference at the expense of other oil-producing states." 462 U.S. at 85–86.

Equally, in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974), the Supreme Court considered a challenge to the Rail Reorganization Act of 1973, on the ground that it violated the bankruptcy uniformity requirement (Article I, Section 8, clause 4) because it operated only in a single statutorily defined region. Although the Court acknowledged that "the argument has certain surface appeal," it concluded that it "is without merit because it overlooks the flexibility inherent in the constitutional provision." 419 U.S. at 158. As the Court observed, "[t]he uniformity provision does not deny Congress power to take into account differences that exist between different parts of the country, and to fashion legislation to resolve geographically isolated problems." 419 U.S. at 159.

The Supreme Court's recent decisions provide a basis for Congress to consider Puerto Rico's unique circumstances when structuring tax legislation. We believe that the retention of the section 936 preference as a transitional measure could, if supported by adequate Congressional findings, be justified as taking into account localized problems unique to Puerto Rico particularly, the economic dislocation that would result to an already economically depressed state from a sudden and immediate termination of the section 936 benefits. We believe that it is within Congress' powers under Article IV of the Constitution, concerning both the admission of new states to the Union and the governance of United States territories, to ameliorate the economic dislocation occasioned by Puerto Rico's admission into the Union.

Retention of the pre-existing tax benefits for a limited transitional period narrowly-tailored to the goal of avoiding severe economic dislocation in Puerto Rico should, in our view, satisfy the requirements of the Tax Uniformity Clause. As stated by the Supreme Court in the *Regional Rail Reorganization Act Cases*, 419 U.S. 102 (1974), in discussing the analogous Bankruptcy Uniformity Clause, "the uniformity clause was not intended to 'hobble Congress by forcing it into nationwide enactments to deal with conditions calling for remedy only in certain regions.'" 419 U.S. at 159 (citation omitted).

In light of the uniformity provisions in the Constitution, section 213(d) must represent a direct, tailored response to a geographically isolated problem: namely, the economic dislocation that would otherwise occur upon Puerto Rico's admission to the Union. In his testimony, the Assistant Secretary of the Treasury noted that the 936 credit accounts for 12 percent of total Puerto Rican employment. And, the Report of the Energy and Natural Resources Committee points out that the unemployment rate in Puerto Rico for 1988 was 15.9 percent, or approximately three times that of the United States. S. Rep. No. 120, 101st Cong., 1st Sess. 38 (1989). We believe that additional Congressional findings concerning the magnitude of this economic dislocation would be helpful. The legislative history of S. 712 should demonstrate that each special provision addresses a particular problem in Puerto Rico. We concur with the views of the Assistant Secretary of the Treasury and join him in encouraging further fact-finding to support a determination that the limited extension of the section 936 benefits is designed to address a geographically isolated problem.

II. STATEHOOD GRANTS AND ASSISTANCE

Section 213(e) of the bill would provide for several so-called "cover-over" mechanisms. Under this section, revenues derived from certain Federal taxes collected in Puerto Rico would be deposited into the Treasury of Puerto Rico: first, the cover

over of the rum excise tax would be continued after statehood; second, the revenues collected in Puerto Rico from any new Federal excise tax would be covered over. The bill provides that "[a]s a compact with the State of Puerto Rico," no alterations would be made in these cover-over provisions until after October 1, 1998. Finally, the revenues derived from the application of the Federal internal revenue laws within the State of Puerto Rico in 1994 and 1995 would also be covered over.

Since the passage of the Second Organic Act, also called the Jones Act, in 1917, the United States Treasury has consistently covered over into the Treasury of Puerto Rico revenues from manufacturing excise taxes on liquor and tobacco produced in Puerto Rico and transported to the United States. The cover-over provision was enacted as part of the Puerto Rican Federal Relations Act of 1950, Pub. L. No. 600, 64 Stat. 319 (1950), and is currently codified at 26 U.S.C., Sec. 7652(a) (3). See *Com. of Puerto Rico* v. *Blumenthal*, 642 F. 2d 622, 623 (D.C. Cir. 1980).

The "covering over" provision of Section 7652 of the Code constitutes an indefinite appropriation arising out of Congress' powers under the General Welfare Clause. The Supreme Court has held that Congress' powers "to provide for * * * the general Welfare" are quite expansive. It has stated (*Buckley* v. *Valeo*, 424 U.S. at 90-91 (quoting *United States* v. *Butler*, 297 U.S. 1, 66 (1936) (citations omitted)):

> It is for Congress to decide which expenditures will promote the general welfare: "[T]he power of Congress to authorize expenditure of public moneys for public purposes is not limited by the direct grants of legislative power found in the Constitution."

Consistent with this language, the Supreme Court has been extremely deferential to exercises of the Congressional power to tax and spend for the general welfare. See *Helvering* v. *Davis*, 301 U.S. 619, 640 (1937).

In light of the Supreme Court's construction of the General Welfare Clause, as well as Congress' authority to admit new states to the Union, it is highly unlikely that the "cover-over" provisions of S. 712 would be held unconstitutional. Indeed, the cover-overs might properly be viewed as merely replacing funds that would otherwise have to be appropriated to deal with Puerto Rico's economic problems.

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This concludes my prepared statement. I will be happy to respond to your questions.

Prepared Statement of Carlos Romero-Barcelo

Mr. Chairman, thank you for inviting us to testify today. It is an honor to participate in the historic process that ultimately will lead to Puerto Rico's entrance into the Union as the 51st State.

My name is Carlos Romero Barcelo. I am here today in my capacity as President of the New Progressive Party of Puerto Rico, the pro-statehood party. I served two terms as Governor of Puerto Rico; also as the Mayor of San Juan. I am a life-long member of the Democratic Party.

I am privileged to be here with Governor Luis Ferre, Chairman of the Republican Party of Puerto Rico, the founder of the New Progressive Party, and a man who has inspired generations of Puerto Ricans in our quest for political equality.

I come today to address two issues: First the unavoidable duty of Congress to provide U.S. citizens residing in Puerto Rico with their basic rights; second, my reasons for believing that statehood would provide important economic benefits both for the people of Puerto Rico and for the Federal government.

Now—I believe largely attributable to the movement of this legislation—independent polling in Puerto Rico demonstrates a majority favors statehood. here has been an ever-growing preference for statehood among the people of Puerto Rico, which is now manifesting itself in public opinion polls because Congress finally has begun to demonstrate its willingness to promote a plebiscite and, if Puerto Ricans elect statehood, to bestow it. The people of Puerto Rico owe an enormous debt to Senators Johnston, McClure, the leaders of this Committee, and other legislators who have propelled S. 712 this year.

We support S. 712 and hope the Finance Committee and the full Senate will act favorably on S. 712 as promptly as possible.

But discussion of S. 712 must begin with a discussion of essential constitutional rights.

I. CONGRESS' DUTY TO PROVIDE PUERTO RICO'S U.S. CITIZENS WITH CONSTITUTIONAL RIGHTS

A. Common Goal: Self-Determination

We are living in one of Democracy's finest hours. People in every part of the world are struggling to exercise the most fundamental right: the right of self-determination. Europe's eastern bloc is moving en masse toward Democracy. In Asia, Africa, and Central and South America, the people will not long be denied. And, with this legislation, the longstanding promise of self-determination for the world's oldest colony finally will be realized for the 3.3 million American citizens living in Puerto Rico.

I was struck by Chancellor Kohl's comments last week before the German Parliament:

> Let us avoid the temptation to assume that a solution to the German question can be arranged in advance with a script and a calendar. History doesn't follow a schedule.
>
> The precondition for reunification in freedom is the free exercise of the right of self-detention by all Germans. I am certain that if they get the chance, they will choose freedom and unity. (emphasis supplied)

I am certain that Puerto Ricans, if they get the chance, will choose statehood and full vesting of their civil liberties and constitutional rights.

The most basic right guaranteed by Democracy is the right of self-determination. Mr. Chairman, you will hear from three very dedicated political leaders. We differ strongly on matters of policy—on how to promote the economic development Puerto Rico and how Puerto Rico should be related to the United States.

But let us not lose sight of the common objective: that Congress enact this legislation authorizing a referendum Whatever our differences, that is our common goal. There is nothing partisan about this objective. Self-determination has been the commitment of every American President since Harry Truman.

B. The Right To Vote; The Right To Representation; And Other Constitutional Rights

For nearly a century since the Spanish-American War, the United States and Puerto Rico have shared a common bond, a common heritage, and a fruitful interweaving of our societies.

Since 1917, Puerto Ricans have been citizens of the United States. We are 3.3 million American citizens living in Puerto Rico: more than live in 27 States now represented in Congress.

More than two million Puerto Ricans live, work, and vote as fully-empowered citizens all across the United States, in addition to the 3.3 million Puerto Ricans who live on our island. Puerto Ricans who have moved to the mainland can vote, unless they move home to Puerto Rico.

In every war since World War I, Puerto Ricans have fought under the American flag, defending the principles for which it stands.

Nearly 200,000 Puerto Rican citizens have served the United States in this century's major wars. Many paid the ultimate price for the Cause of Democracy. In the Korean War, for example, Puerto Rico was second among all States in the number of wounded and third in the number of battle deaths, although we are 26th in population when compared to the 50 states.

Our cultures have been enriched by our close association Musicians like Pablo Casals, opera singers like Justino Diaz, actors like Jose Ferrer and Raul Julia, and athletes like Roberto Clemente, Chichi Rodriquez, and Angel Cordero, have achieved fame not only in America, but around the world. Every one of these notable Puerto Ricans can vote as American citizens, except when they reside at home.

Our economies have virtually become one. More than 75 percent of our consumer goods are produced in the 50 States. More than 90 percent of our industry derives from mainland U.S. businesses.

With such a close bond, some people ask why Puerto Rico wants to change the current status and become the 51st State.

The answer is simple—because we do not have equal right.

We are U.S. citizens, yes, but with a difference—we are second-class citizens who have no voice in our Nation's future, who have no vote in Washington.

Puerto Ricans are a talented people, a hard-working people, a proud people. We are not free-riders.

What we seek is to become full-fledged citizens, with the same rights and responsibilities as Americans in Texas, Oregon, or any American city or state.

I believe the case is compelling for Puerto Rico to become the 51st State.

There are four compelling reasons why Puerto Rico should become the 51st star on the American flag.

The fat goes back to the first thirteen stars on that American flag. The American Revolution was fought to give people the right to decide their own destiny. Puerto Ricans seek no less.

We are subject to the laws of Congress. But more than three million Puerto Ricans, more than three million U.S. citizens, have no vote here in Congress. That is not right. Lack of representation was not right in the thirteen colonies in 1775, and it is not right in Puerto Rico in 1989.

Puerto Rico is subject to a patchwork of Federal laws, some of which are the same as they are here on the mainland, some of which are specifically written for our island. But all these laws governing Puerto Rico share a common feature—not one Puerto Rican had a vote to determine what those laws were going to be.

The second reason Puerto Rico should be the 51st State is because we have earned the right to become full-fledged American citizens—and many Puerto Ricans earned it the hard way, with their lives. I mentioned earlier the numbers of Puerto Ricans who have served and died.

Behind those numbers were heroes, Puerto Rican heroes, American heroes. When American planes sought to avenge the bloody terrorism of Muhammar Quadafi's Libya, a Puerto Rican Air Force Commander was in the eye of the raid. And Major Ribas-Dominicci gave his life for his country.

His mother did not vote for the President who gave the order to take action against Libya. She had no right to vote—she lives in Utuado, Puerto Rico.

The United States, in its long march to overturn inequality, has historically reversed past patterns of discrimination. Other men and women have fought in the Nation's wars when they too were disenfranchised. In World Wars I and II and in the Korean War, men and women served and died at a time when neither they nor their parents could vote. They came from Alaska and Hawaii; they came from southern States; they were below the age of 21. They could fight, but not until the 1960's and early 1970's were they granted full voting rights.

The nature of the "Commonwealth" or territorial status is undemocratic in itself. It seems preposterous to suggest that the Congress of the Nation which is the example of Democracy throughout the world can sponsor, encourage or support a relationship between the 50 States and a territory of 3.3 million U.S. citizens based on permanent disenfranchisement.

The third reason for Puerto Rican statehood is international relations and national security. Just as Puerto Rico needs the United States, the United States needs Puerto Rico. The U.S. Navy Base at Roosevelt Roads is the largest in the world outside the mainland U.S. and it is vital to our hemispheric and international security.

Puerto Rico is at the crossroads of the Caribbean and North, South, and Central America If the security of twentieth century America focused on Europe and Asia, then it is clear that the security of twenty-first century America could well center on this hemisphere. We need look no further than Cuba, Panama, Nicaragua, and the drug lords in South America to realize the foreign policy challenges we face.

The Caribbean region is vital to U.S. national security. With the impending withdrawal of U.S. troops from the Panama Canal Zone in the year 2000, America must strengthen its presence, as it would under statehood.

Admission of Puerto Rico as a State will demonstrate to Central America and South America, in an irrefutable way, that the United States is genuinely hospitable to Hispanic language and culture. The present territorial relationship is one in which decisions are made for the territorials in the national capital, without their participation. That sends one signal to Latin America

Statehood, in which Puerto Ricans take part in choosing the American President, and elect actual voting members to the Senate and the House, sends quite another signal. I do not know how many billions in foreign aid and debt forgiveness such a signal is worth, but surely it has great value for America's standing in the eyes of Latin Americans.

And the fourth reason Puerto Rico should become a State can be summed up in two words—the future. The first thirteen of these United States made a great, free and prosperous Nation. And that Nation became greater, freer, and even more prosperous as each new State was added. When the Louisiana Purchase was made, many Americans scratched their heads and asked what would they ever do with all that worthless land. When William Seward committed his "folly," buying Alaska, people thought he was crazy.

But today you cannot imagine what America would be like without the States of the Louisiana Purchase, without the State of Alaska I am confident that in a few decades time, the citizens of the United States will look back and not be able to imagine a time when Puerto Rico was not the 51st State of our Union.

The fifty States have been woven together so fully that succeeding generations forget how young our Republic is, and how many obstacles new States had to overcome. How many American citizens know, for example, that Oklahoma and New Mexico were admitted as late as 1907 and 1912, and that one of the obstacles they had to overcome was the objection that they were bilingual? How many American citizens know that Alaska had to fight for admission for over 60 years and overcome the serious objection that Alaska might never be able to pay its way? For that matter, how many know that the enabling legislation to admit Colorado to the Union was vetoed over that same issue? How many know that the average value of Federal statehood grants to all the territories (to facilitate transition to statehood) exceeded $48,000 per resident in 1989 dollars.[1] Those investments, viewed as folly in their day, are now regarded as acts of genius. To study the process of admission of the 37 states that so far have been incorporated to the original 13 is to understand the greatness of this nation and the reasons for its success.

The genius of the American experiment in Democracy is that the United States has never stopped growing, not just in size and population, but in the diversity, strength, and freedom of its people. Always a "more perfect union."

Puerto Rico has been a "member" of the Union, although on a hybrid basis, since 1898. In 1918, Congress determined that it should have a separate tax structure. But the Puerto Rican people have been United States citizens since 1917; they have bled for their country and they have earned the opportunity that the pending bill would bestow: the chance to express their preference regarding the type of relationship they should have with the mainland with an advance knowledge that Congress has blessed their endeavor. They have earned the right to a bill with consequences, not just an expensive poll, not just an exercise in futility.

II. WHY STATEHOOD IS INDISPENSABLE TO PUERTO RICO'S ECONOMY

People sometimes ask me, "Why upset the status quo, why not just remain a territory tied to the United States, getting the best of two worlds? Why would you want to pay Federal taxes?"

Puerto Rico has made progress as a territory. But no matter how much economic progress we make as a territory, we will never be equal; we will always be second-class citizens without participation in the decisions that affect our Nation's future. Moreover, we will never develop a healthy, balanced economy. With an economy dependent on tax favoritism that can be withdrawn at any time—an economy on borrowed crutches—we will always lag behind.

From the Congress' point of view, statehood is the only option of the three under which Puerto Rico will contribute to the Federal Treasury, and not simply make claims upon it.

The difference is dramatic. The cost of commonwealth rises every year by several hundred million dollars. Last year, commonwealth cost the Federal Government a minimum of $5.2 billion. Commonwealth's annual cost will rise steadily to more than $9 billion during the 90's. Commonwealth offers no hope for ending—or even reducing—this revenue drain. Commonwealth is a bottomless pit, a "black hole," and its supporters want it to go on *ad infinitum.*

True, statehood would be more costly to the U.S. Treasury, but only during the initial transition years. But in the second half of the 1990's the Federal Government would begin to realize net revenue gains in comparison to commonwealth status. Compared with commonwealth's perpetually rising Federal revenue losses, statehood would yield a continuous annual net budget gain for the Federal Government. In fact, compared with commonwealth, the Federal Government would recoup *all* of the transitional revenue losses within a short number of years after the transition. THUS FISCAL PRUDENCE IS ONE REASON WHY CONGRESS SHOULD WISH TO MAKE STATEHOOD POSSIBLE FOR PUERTO RICO.

From Puerto Rico's viewpoint, this conclusion is inescapable: only statehood will enable Puerto Rico to develop a viable economy.

Opponents of statehood claim that Puerto Rico would suffer serious economic side effects from the imposition of Federal income taxes and the loss of Section 936 tax incentives. The facts are exactly the opposite. It is under territorial status that Puerto Rico's economic development is uncertain.

Mr. Chairman, in discussions with committee members I have heard serious questions about S. 712 and about what statehood will mean for Puerto Rico. I will take a few moments to address these questions because they affect the core issues which you and your colleagues must resolve.

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[1] See Table 1 (enclosed).

A. Can Puerto Rico Prosper Without Section 936?

As a state, with a reasonable transition, Puerto Rico can and certainly will prosper without action 936. However, I would hesitate to predict the economic consequences for the Puerto Rican "commonwealth economy" without Section 936.

Puerto Rico, with the use of the tax exemption allowed by Section 936 and through other competitive incentives, has developed a manufacturing economy more advanced than any other in the Caribbean or bin America. The people of Puerto Rico appreciate the support Congress has been willing to provide for a tax incentive that is important so long as Puerto Rico remains a territory. But the Section 936 program has matured: it now draws capital intensive industries (themselves indispensable) more than labor intensive businesses, without which Puerto Rico cannot expand employment meaningfully. Moreover Section 936 is encouraging progressively more unbalanced and unsustainable growth. When one segment of an economy is disproportionately subsidized with tax benefits, capital investment is drawn to that segment at the expense of others.

With respect to Federal economic programs that would help to diversify Puerto Rico's economy, Section 936 crowds out alternatives. (Members of this Committee will recall that the Treasury's proposal several years ago for a wage credit—as a partial substitute for Section 936—went absolutely nowhere.)

Section 936 unavoidably would be phased out under statehood. Because Puerto Rico's economy has relied on Section 936 benefits for so long, a smooth transition is desirable. For this reason we believe Congress should provide for the longest phaseout of Section 936 consistent with prudent budgeting.

But, some ask, won't companies which qualify for Section 936 benefits, upon its demise, leave Puerto Rico? Would that wipe out one-third of Puerto Rico's total employment, as the commonwealth supporters allege? What would replace Section 936 as an inducement for business investment in Puerto Rico?

I may sound chauvinistic, but let me say candidly that I find such questions unnecessarily negative. There are many good reasons why companies that now avail themselves of Section 936 would remain in the new State of Puerto Rico and why others would come.

1. Advantages Of Statehood

A senior executive of one Section 936 company—a large Puerto Rican employer—told me his company would open its headquarters for the Caribbean and Latin America in the State of Puerto Rico. So long as Puerto Rico remains a commonwealth, his company has no such plans. It will reap the benefits of Section 936, nothing more.

Puerto Rico enjoys a tremendous strategic location for U.S. companies doing business with Central America, Latin America, the Caribbean. The same is true as well for foreign companies--especially for Latin American companies, but also for Japanese and European companies—doing business with U.S. concerns.

Puerto Rico has a skilled labor force and a lower cost structure than the mainland. Mainland businesses will operate in Puerto Rico if efficiencies are high and unit costs are low.

Puerto Rico also offers an incomparable natural environment. It will draw businesses, investors, and tourists.

Add statehood to these natural advantages and you have the formula for success.

If you were a businessman, would you invest in a strategically located state more readily than in a well-situated territory or "commonwealth?"

Of course. It's a matter of risk analysis. The commitment of the national government to the stability and well-being of its states is decidedly different than its commitment to a loosely affiliated territory, particularly when the state has two senators and six congressmen watching out for its interests.

Please ask Senators Matsunaga and Inouye what statehood brings. They will recall that in Hawaii opponents of statehood argued that resulting increased taxes would cause economic collapse.

An excellent book about the statehood process titled "Breakthrough From Colonialism," sums up the argument made then against Hawaiian statehood:

> Statehood would bring rising expenditures and increased taxes which in turn would make it difficult to attract new industries and would also drive away from the Islands many established firms. In short, statehood would bring about the economic collapse of Hawaii . . .

> Independence or Commonwealth status was preferable to statehood especially since the latter offered certain tax advantages which no State could enjoy.[2]

And what happened when Hawaii became a State? Did Hawaii suffer an economic collapse as predicted?

No. On the contrary. In 1970, the First Hawaiian Bank published a report titled "Hawaii in 1969—Alter a decade of statehood." The growth rates of Hawaii under statehood shown in that publication are incredible.

- The per capita personal income jumped from $1,987 in 1959 to $3,513 in 1969.
- Bank private demand deposits rose from $220.3 million in 1959 to $524.2 million in 1969.
- Total personal income rose from $1,178 million in 1959 to $2,705 million in 1967.
- Civilian employment rose from 204,450 in 1959 to 294,850 in 1969. The growth of tourism was remarkable. In 1959 visitors to Hawaii numbered 243,000. In 1969, Hawaii had 1.4 million visitors. An increase of 476 percent in 10 years. In 1959 Hawaii had 6,802 rooms for visitors. In 1969 Hawaii had 25,882 rooms. Hotel employment in 1959 was 3,700 persons. In 1969 hotel employment was 13,150.

This kind of economic expansion is precisely what can and should be expected in Puerto Rico after we become a State.

2. Would The Demise Of Section 936 Cost Puerto Rico One-Third Of Its Employment?

The "one-third" figure is misleading. Even if all the Section 936 companies left—a false premise I will address momentarily-Puerto Rico would lose only about 10 percent of its employment. The one-third statistic refers to direct employment in Section 936 companies plus derivative jobs which the 936 stimulus purportedly creates throughout Puerto Rico's economy. Put plainly: for every Section 936 job, two "jobs supposedly are created in Puerto Rico's economy.

Neither the Section 936 jobs nor the derivative jobs would disappear if Section 936 were phased out in favor of statehood. And the reason is that statehood provides certainty and brings with it economic stimuli more significant than Section 936 for Puerto Rico's economy.

In point of fact, the issue is purely academic Most Section 936 companies would not leave the state of Puerto Rico. Those which elected to leave would be replaced. In fact, those that would leave are already leaving—and they tend to be the more labor intensive operations.

3. Why Section 936 Companies Won't Leave Puerto Rico

The decision to abandon a capital investment is different than an initial decision whether or not to invest. Once one builds a plant, hires workers and establishes an efficient operation, only a powerful motive causes one to pull up roots.

The Section 936 companies have built sophisticated, profitable operations in Puerto Rico. Puerto Rican productivity is high and unit costs are lower than on the mainland. They will prefer to retain those operations and pay Federal taxes in the State of Puerto Rico rather than moving to the mainland, where they would pay both Federal taxes and higher unit costs. Congress also has enacted disincentives to discourage their uprooting to a foreign country to avoid U.S. taxes.

These factors will encourage Section 936 companies to stay in Puerto Rico at least until their products become obsolete: until a prolonged period of patent protection expires. I also have faith that Congress—as it has for other States entering the Union—will provide Puerto Rico with a reasonable economic transition. Thus Section 936 would not end precipitously. As Section 936 phases out, the State government—as many State governments do—will want to work with the companies to preserve Puerto Rico's attractiveness

If some Section 936 companies decide over time to leave, they will want to sell their Puerto Rican plant and operation at an attractive price. This means selling the business as a going concern. They will find buyers on the open market: some domestic, some foreign. In this age of employee buy-outs, they also will find entrepreneurial Puerto Ricans ready to buy the operations they have made profitable. It could turn out to be a blessing in disguise.

Puerto Rico has become a manufacturing economy. Under statehood Puerto Rico will remain a manufacturing economy with a difference. Al Section 936 phases out, capital investment and economic stimuli should broaden into other segments of the economy. This will produce a more balanced, healthier economy, and ultimately a better standard of living for more Puerto Ricans.

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[2] "Breakthrough From Colonialism," pages 967, 969.

B. IS IT DESIRABLE TO MAKE PUERTO RICANS FULLY ELIGIBLE FOR FEDERAL SOCIAL PROGRAMS?

Not only is it desirable. It is imperative.

Some will say the Federal costs appear high. Some will argue that full eligibility may create permanent dependency, a "welfare state." I have a simple answer for them.

Open your eyes. COMMONWEALTH IS THE ULTIMATE WELFARE STATE: a one-dimensional economy dependent on Section 936 and other tax holidays, with many people, not benefiting from Section 936, dependent on social welfare programs.

Moreover, Commonwealth masks an insidious hidden Federal cost. Did you know that 2.3 million Puerto Ricans have moved to the mainland, many to become eligible for federal benefits?

And what of the poor who stay in Puerto Rico? They are the tragic victims of commonwealth status. But for commonwealth status and the discriminating Federal treatment it permits, these poor would be entitled to constitutionally guaranteed Federal benefits.

You will ask whether Congress should provide these poor with Federal benefits, or can afford to do so. Are they deserving? Would the benefits make them forever dependent? How costly would it be?

Let's look at three of the most costly new benefits that would become available. You decide.

- *Earned Income Tax Credit:* (a) Does the EITC foster permanent dependency? No, just the opposite. It is designed to put people to work. And it works. (b) Are the beneficiaries truly needy? They are the working poor with children: the poorest segment of the U.S. population and, until the EITC, the most poorly treated.
- *Replacement of AABD*[3] *with SSI:* It is academic to ask whether this change would foster permanent dependency. The program's recipients are the nation's dependents: the aged, the blind, the disabled—the ones who don't qualify for Social Security. Are they deserving? These are the people beneath whom a civilized society is supposed to place a safety net. But in the American society, if they happen to live in Puerto Rico—a commonwealth—a couple must live on $64 per month plus 50 percent of actual shelter costs while their fellow citizens living in states receive $533 per month.
- *Medicaid:* Medicaid recipients are demonstrably poor, many are chronically ill. Eligible low-income people include the aged, the blind, and members of families with dependent children—again the population for whom the social safety net is designed. For Puerto Rico's 1.7 million eligible people, average 1987 expenditures were $58 versus $1,005 for mainland beneficiaries.

Providing full benefits under statehood to U.S. citizens residing in Puerto Rico will be more costly for a time; but less costly than continued commonwealth by the second half of the 90's. That's right. The Federal Government can eliminate the tragic discrimination against Puerto Rico's poor and eventually save money, in fact reap a surplus. America can afford to do no less.

That's not all. Several important by-products will occur. The infusion of Federal payments into Puerto Rico's economy will create jobs and help in the transition to statehood, since it will create a greater demand for goods and services which, in turn, will produce more tax revenues for the Federal and Puerto Rican governments. And as the economy grows and diversifies, opportunities will expand for Puerto Ricans who receive the EITC and other incentive-based benefits to work their way out of eligibility, and the welfare rolls will be reduced.

C. Is S. 712 Tilted Towards Statehood?

Before I close, let me address an issue that has been raised with many Members of the Senate by supporters of commonwealth—the issue of the bill's alleged "tilt" towards statehood.

Commonwealth supporters suggest that Puerto Rican voters will be prejudiced towards statehood because, after statehood, S. 712 confers upon Puerto Ricans the federal social benefit payments available to the citizens of every State whereas commonwealth confers no such parity. One might argue that exactly the opposite is true, that any bill allowing for statehood which imposes individual income taxes on U.S. citizens of Puerto Rico and ends Section 936 benefits could prejudice voters against statehood and towards commonwealth.

Here is why commonwealth supporters have resorted to this "tilt" argument.

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[3] Puerto Rico's program for Aid to the Aged, Blind, and Disabled

An earlier version of S. 712 contained a "wish list" of provisions submitted by commonwealth for the Energy Committee's consideration. Together, the provisions were supposed to create a new status: "enhanced commonwealth." But the Energy Committee sensibly—unavoidably rejected many of the proposals.

- The committee rejected a host of provisions—for example, authorizing Puerto Rico's governor to issue U.S. passports and requiring the President to appoint Federal officials from a list of candidates recommended by the governor—because the Justice Department testified that they would have been both unconstitutional and broader than the authority enjoyed by governors of the fifty states. They even asked for the power to veto legislation approved by Congress and the President. Not to mention their request for the authority for the governor to negotiate international treaties.
- Advocates asked that commonwealth be "enhanced" with an assurance that, under commonwealth, the following programs would achieve full parity with the fifty states: Nutrition Assistance Program, Aid to Families with Dependent Children, Medicaid, and the Supplemental Social Security Income program. (There was no request that Puerto Ricans receive the earned income tax credit: under commonwealth Puerto Ricans generally pay no individual Federal income tax.) This proposed parity also was rejected.

Energy Committee did not endorse these proposals. As a result, commonwealth advocates complain to you about "tilt": full benefits become available to Puerto Ricans with the advent of statehood, while there is no requirement for such parity under commonwealth.

Please evaluate the commonwealth claim in the light of what the Energy Committee said in the "Economic Adjustment" section of its report:

> . . . this section is not optional, nor a matter of Committee generosity, nor an attempt to tilt the legislation toward statehood. This provision is constitutionally required.

Governor Hernandez Colon testified last week that he visualizes the commonwealth relationship as permanent. Think about that from a Puerto Rican's perspective:

- We are second class citizens: with no vote and practically no congressional representation. However "enhanced," commonwealth cannot eliminate that unequal status.
- The Supreme Court has called commonwealth "a relationship to the United States that has no parallel in our history." The Court says Congress may discriminate against Puerto Rico—and Congress has done so—so long as there is a rational basis for its actions. No Congress can bind a future Congress. Any Congress can elect to alter the terms and conditions of Puerto Rico's relationship with the United States. What are "enhancements" worth when they may be removed unilaterally by Congress at any time?
- And, as governor, I have lobbied Congress ("begged" is a more accurate word) unsuccessfully for commonwealth parity in social programs. I am a realist: what sorts of "enhancements" will Congress grant to a citizenry that pays no Federal taxes?

Now consider "permanent commonwealth" from the Federal Government's perspective.

- Commonwealth is an endless drain on the Treasury. Do you want to pour billions each year into an economy loosely related to the United States, one whose citizens barely pay Federal taxes? Commonwealth proponents believe the U.S. Treasury to be the horn of plenty: a cornucopia where we may freely come to whenever in need, with no obligation or the slightest attempt to replenish.
- And until Puerto Ricans can vote and are fully represented in Congress, and pay their share of Federal taxes, will you feel any serious pressure to bring Puerto Rico and Puerto Ricans to a condition of parity?

Commonwealth is not permanent and it cannot be "enhanced" sufficiently to equate with statehood. What commonwealth witnesses call "tilt" are constitutional guarantees available only to the fifty States and their citizens. That's the American system. It won't change because commonwealth wishes it were so. The Puerto Rican people recognize this. So must this Committee.

Mr. Chairman, Members of the Committee, statehood alone will bring equality and a viable economy to Puerto Rico. Statehood is the only realistic hope for the federal government and for the people of Puerto Rico. Let the people of Puerto Rico speak. They will speak for statehood.

Thank you

TABLE 1 — LAND AND MONETARY GRANTS RECEIVED BY STATES AT TIME OF ADMISSION

State	Year entered union	Land grant (million acres)	Total state land (million acres)	State population		State real property value, 1981 (billion)	Value of State land		Value of State land grant 1989 prices 3/	
				year of admission (million)	1980 census (million)		1981 prices 1/ (billion)	1989 prices 2/ (billion)	total (billion)	per person (thous) 4/
Alabama	1819	5.007	32.678	0.130	3.894	$51.397	$20.045	$37.179	$5.887	$58.567
Alaska	1959	104.569	365.481	0.226	0.401	$13.507	$5.268	$9.771	$2.795	$12.360
Arizona	1912	10.543	72.688	0.204	2.718	$88.219	$34.405	$63.815	$9.256	$45.294
Arkansas	1836	11.937	33.599	0.080	2.286	$43.974	$17.150	$31.810	$11.301	$141.266
California	1850	8.825	100.207	0.093	23.668	$864.113	$337.004	$625.075	$55.049	$594.506
Colorado	1876	4.472	66.485	0.194	2.890	$112.225	$43.768	$81.180	$5.480	$28.099
Connecticut	1788	0.180	3.136	0.238	3.108	$99.208	$38.740	$68.148	$3.913	$16.444
Delaware	1787	0.090	1.266	0.059	0.594	$13.587	$5.291	$9.814	$0.888	$11.806
Florida	1845	24.214	34.721	0.054	9.747	$315.394	$123.004	$228.147	$159.107	$2,920.629
Georgia	1788	0.270	37.295	0.083	5.463	$103.491	$40.361	$74.863	$0.542	$6.566
Hawaii	1959	0.000	4.106	0.633	0.965	$47.947	$18.699	$34.684	$0.000	$0.000
Idaho	1890	4.254	52.933	0.089	0.944	$26.183	$10.211	$18.940	$1.522	$17.100
Illinois	1818	8.235	35.795	0.035	11.427	$239.126	$93.259	$172.977	$30.130	$860.864
Indiana	1816	4.341	23.158	0.064	5.490	$95.258	$37.150	$68.908	$12.024	$188.175
Iowa	1846	8.061	35.860	0.150	2.914	$96.334	$37.570	$69.685	$15.666	$104.431
Kansas	1861	7.795	52.511	0.107	2.364	$60.016	$23.406	$43.[illegible]	$6.445	$60.114
Kentucky	1792	0.355	25.512	0.074	3.660	$50.816	$19.818	$36.758	$0.511	$6.912
Louisiana	1812	11.441	28.867	0.077	4.206	$68.238	$26.613	$49.362	$19.564	$255.518
Maine	1820	0.210	19.848	0.298	1.125	$24.203	$9.439	$17.508	$0.185	$0.621
Maryland	1788	0.210	6.319	0.320	4.217	$97.101	$37.869	$70.240	$2.334	$7.301
Massachusetts	1788	0.380	5.284	0.379	5.737	$120.387	$46.951	$87.085	$6.188	$16.290
Michigan	1837	12.113	36.492	0.093	9.262	$169.511	$66.109	$122.620	$40.702	$439.198
Minnesota	1858	16.422	51.205	0.150	4.076	$114.088	$44.494	$82.528	$26.468	$176.343
Mississippi	1817	8.098	30.222	0.076	2.521	$36.943	$14.408	$26.724	$5.392	$71.407
Missouri	1821	7.417	44.248	0.067	4.917	$85.989	$33.626	$62.187	$10.424	$158.660
Montana	1889	5.963	93.271	0.143	0.787	$21.471	$8.374	$15.532	$0.993	$6.944
Nebraska	1867	3.459	49.031	0.029	1.569	$48.414	$18.101	$33.575	$2.369	$82.128
Nevada	1864	2.725	70.264	0.016	0.800	$29.424	$11.475	$21.285	$0.825	$50.413
New Hampshire	1788	0.150	5.768	0.142	0.921	$22.019	$8.587	$15.928	$0.414	$2.919
New Jersey	1787	0.210	4.813	0.184	7.365	$170.066	$66.321	$123.013	$5.367	$29.148
New Mexico	1912	12.705	77.766	0.327	1.303	$29.347	$11.445	$21.229	$3.468	$10.587
New York	1788	0.990	30.650	0.340	17.558	$282.374	$110.126	$204.262	$5.581	$16.379
North Carolina	1789	0.270	31.482	0.394	5.880	$117.984	$46.014	$85.348	$0.732	$1.859
North Dakota	1889	3.264	44.452	0.191	0.653	$17.070	$6.657	$12.348	$0.907	$4.747
Ohio	1803	2.759	26.122	0.042	10.798	$219.111	$85.453	$158.499	$16.741	$399.394
Oklahoma	1907	3.095	44.087	1.414	3.025	$70.158	$27.362	$50.749	$3.563	$2.519
Oregon	1859	7.032	61.599	0.052	2.633	$96.966	$37.825	$70.157	$8.009	$152.656
Pennsylvania	1787	0.180	28.804	0.434	11.865	$199.253	$77.709	$144.134	$0.903	$2.080
Rhode Island	1790	0.120	0.677	0.069	0.947	$16.640	$6.490	$12.182	$2.159	$31.373
South Carolina	1788	0.160	19.374	0.249	3.121	$54.738	$21.348	$39.596	$0.368	$1.477
South Dakota	1889	3.435	48.882	0.349	0.691	$21.375	$8.336	$15.462	$1.087	$3.113
Tennessee	1796	0.300	26.728	0.077	4.591	$85.998	$33.539	$62.209	$0.698	$9.037
Texas	1845	0.180	168.218	0.243	14.225	$386.753	$150.834	$279.768	$0.299	$1.234
Utah	1896	7.502	52.697	0.277	1.461	$35.528	$13.856	$25.700	$3.659	$13.220
Vermont	1791	0.150	5.937	0.241	0.511	$12.693	$4.950	$9.182	$0.232	$0.963
Virginia	1788	0.300	25.496	0.692	5.347	$117.336	$45.761	$84.876	$0.999	$1.444
Washington	1889	3.044	42.694	0.357	4.132	$130.041	$50.716	$94.068	$6.707	$18.775
West Virginia	1863	0.150	15.411	0.377	1.950	$26.275	$10.247	$19.007	$0.185	$0.491
Wisconsin	1848	10.183	35.011	0.250	4.705	$106.590	$41.570	$77.104	$22.419	$89.677
Wyoming	1890	4.353	62.345	0.062	0.469	$13.719	$5.350	$9.924	$0.693	$11.077
AVERAGE										$45.189
TOTAL		128.415	2,271.320	10.594	225.896	$5,361.780	$2,091.098	$3,878.548	$524.738	

1/ Estimated as 39% of real property values. This percentage determined by Manvel (1983).

2/ Adjustments to 1989 prices are based on real historic land appreciation of 4.1% (based on data from 1964 to 1987) plus CPI inflation from 1981 to 4/1989.

3/ State land values in 1989 prices (estimated from market values of all assessed ordinary real property) times the proportion of the state's land granted.

4/ Value of grant in 4/89 (1989 dollars) divided by population at time of admission (millions).

5/ $0.000 means monetary grant was less than $500,000.

PREPARED STATEMENT OF CHARLES E. SEAGRAVE

BACKGROUND MATERIALS ON THE COSTS OF THE PUERTO RICO STATUS REFERENDUM ACT

[PREPARED FOR THE COMMITTEE ON FINANCE, UNITED STATES SENATE, BY THE CONGRESSIONAL BUDGET OFFICE, U.S. CONGRESS, NOVEMBER 15, 1989]

TABLE 1.—COMPOSITION OF 1988 FEDERAL SPENDING IN PUERTO RICO

Spending category	Billions of dollars
Social Security	1.8
Food and Nutrition Assistance	1.1
Defense	.6
Health and Human Services Programs including Medicare	.5
Housing Assistance	.4
Federal Retirement and Veterans Benefits	.4
Education Assistance including Pell Grants	.4
Other	1.0
Total	6.2

Source: U.S. Bureau of the Census.

TABLE 2.—THE ESTIMATED FEDERAL SPENDING EFFECTS OF S. 712

[By fiscal year, in billions of dollars]

	1992	1993	1994	1995
Projected Baseline				
Federal Expenditures in Puerto Rico	7.9	8.3	8.8	9.4
S. 712 Changes under Alternative Status Selections				
1. Enhanced Commonwealth	(1)	(1)	(1)	(1)
2. Independence	(1)	(1)	.1	.3
3. Statehood	1.7	1.8	2.6	3.3

Source: Congressional Budget Office cost estimate of S. 712, November 7, 1989.

[1] Less than $50 million.

TABLE 3.—ESTIMATED INCREASES IN FEDERAL OUTLAYS UNDER STATEHOOD FOR CERTAIN ENTITLEMENT PROGRAMS

[By fiscal year, in billions of dollars]

Programs	1992	1993	1994	1995
Food Stamps	.7	.7	.7	.7
Medicaid	.9	1.0	1.1	1.2
Medicare	.1	.1	.1	.1
SSI	0	0	.6	.9
AFDC	(/1/)	(/1/)	.1	.1
Foster Care	(/1/)	(/1/)	(/1/)	(/1/)
Earned Income Tax Credit	0	0	(/1/)	.3
Total	1.7	1.8	2.6	3.3

Source: Congressional Budget Office cost estimate of S. 712, November 7, 1989.

[1] Less than $50 million.

CONGRESSIONAL BUDGET OFFICE COST ESTIMATE

November 2, 1989.

1. BILL NUMBER: S. 712
2. BILL TITLE: The Puerto Rico Status Referendum Act
3. BILL STATUS: As ordered reported by the Senate Committee on Energy and Natural Resources on August 2, 1989.
4. BILL PURPOSE: To establish guidelines and provide resources for a referendum during the summer of 1991 in Puerto Rico. The referendum will allow Puerto Ricans to choose between statehood, independence, and enhanced commonwealth status. In addition, the bill outlines the transition provisions for entitlement and Federal programs as well as tax issues for each of the options.
5. ESTIMATED COST TO THE FEDERAL GOVERNMENT: This estimate provides only spending estimates for S. 712. Revenue estimates are being developed separately by the Joint Committee on Taxation. The estimated costs to the Federal Government would be very different depending upon which status option—statehood, independence, or enhanced commonwealth—is chosen. The table below shows the total Federal costs under each alternative.

[By fiscal years, in millions of dollars]

	1991	1992	1993	1994	1995
STATEHOOD					
Direct Spending					
Budget Authority		1666	1810	2560	3250
Estimated Outlays		1666	1810	2560	3250
Amounts Subject to Appropriation Action					
Estimated Authorization Level	*	10	10	10	10
Estimated Outlays	*	10	10	10	10
Total Spending					
Budget Authority/Estimated Authorization Level	*	1676	1820	2570	3260
Estimated Outlays	*	1676	1820	2570	3260
INDEPENDENCE					
Total Spending					
Budget Authority/Estimated Authorization Level	*	*	*	100	300
Estimated Outlays	*	*	*	100	300
ENHANCED COMMONWEALTH STATUS					
Direct Spending					
Budget Authority		0	0	0	0
Estimated Outlays		0	0	0	0
Amounts Subject to Appropriation Action					
Estimated Authorization Level	*	*	*	*	*
Estimated Outlays	*	*	*	*	*
Total Spending					
Budget Authority/Estimated Authorization Level	*	*	*	*	*
Estimated Outlays	*	*	*	*	*

* Less than $500,000.

Basis of Estimate

For purposes of the estimate, CBO has assumed that the referendum would occur and be certified in the summer of 1991, and that procedures for implementing the certified status option would go into effect in fiscal year 1992. The bill has three status options that are discussed in turn. The cost of the referendum would be incurred regardless of the option chosen. Although the bill does not state a specific authorization level, CBO estimates the cost of the referendum would be between $2.5 million and $4 million in fiscal year 1991.

S. 712 would require the U.S. Attorney General to provide for adequate monitoring of the referendum by U.S. Marshals. Based on information from the Department of Justice, CBO estimates that these monitoring activities would cost between $.5 million and $2 million in 1991, depending on how the Marshals Service implements this provision.

If they provide a minimal presence of on-call deputy marshals able to respond to disruptions at polling places, then costs would be toward the lower end of the range. If on the other hand, they create a greater presence by providing more marshals to travel to and monitor all 1,602 polling places during the election, then costs would be closer to the higher end of the range. For purposes of this estimate, we assumed that the primary function of the U.S. Marshals would be to insure law and order at polling places and not to insure against election fraud. We therefore did not estimate the costs that would be incurred to provide oversight and security of ballot boxes and machines.

S. 712 also would require the President to appoint a Referendum Information officer to distribute education information on the referendum. The bill authorizes the appropriation of funds to cover the expenses of the Information Officer. CBO assumed that the Information Officer would be appointed by October 1990 and would work through August of 1991. The estimate covers costs for salaries, overhead, printing, and postage. CBO estimates the cost of these activities would be $2 million in fiscal year 1991.

STATEHOOD

If statehood is certified, Puerto Rico would be treated as any other state effective October I, 1991. This option would entitle Puerto Rico to representation in Congress and full participation in Federal entitlement programs. This provision would also provide for a commission to facilitate the transition to statehood.

Senators and Representatives. Beginning January 1992, Puerto Rico would be represented in Congress by two senators and six representatives. At the same time, the office of Puerto Rico's current delegate to the Congress—the Resident Commissioner—would no longer be necessary. The costs of the additional members would be similar to the costs associated with members of Congress from the states with population size similar to Puerto Rico and of similar distance from Washington, D.C. Such costs would total about $7 to $10 million annually. The estimate for 1992 assumes the new members would be sworn in January 1992.

Commissions. S. 712 would require the creation of a seven person commission to examine the applicability of Federal laws in Puerto Rico. The commission would be created within 60 days of confirmation of the election results (beginning of November 1991 at the latest) and would have to submit its report by January 1, 1995. CBO estimates the cost of these activities would be $1 million annually in fiscal years 1992-1994.

Entitlement Programs. While Puerto Rico is considered a state for many federal programs, it is not always treated identically to the rest of the 50 states. For example, Federal funds available for AFDC and Medicaid are capped in Puerto Rico, and the Food Stamp program is administered as a block grant. Also, SSI is currently not available in Puerto Rico, but the Aid to the Aged, Blind and Disabled (AABD) program is. The estimates for the entitlement programs are complex and uncertain in a number of respects. The uncertainties include the benefit levels for each program, the number of participants in each program, the actual amount of time the transition to statehood would take, and the comparability of the program and population in Puerto Rico to the U.S.

Recent detailed data bases that display the characteristics of current program participants and permit estimates of potential participants are not available for Puerto Rico. This lack of data complicates the estimating process and increases the uncertainty of the estimates. Finally, many of the Federal programs, in particular AFDC and Food Stamps, are sensitive to the condition of the economy, particularly the unemployment rate. If the Puerto Rican economy should change under statehood, the costs to the Federal government for these programs could change significantly. For example, participation in the Food Stamp and AFDC programs would be higher, if unemployment increased significantly.

Food Stamps. Extending food stamps to Puerto Rico is estimated to increase federal costs by $700 million annually in 1992-95. This estimate assumes a Food Stamp program cost of $1.7 billion in 1992, less $1.0 billion for the existing Nutrition Assistance Program. The $1.7 billion estimate assumes average monthly participation of 1.75 million persons, average monthly benefits of $77 per person, and administrative costs of $115 million. Participation is estimated to remain constant in 1992-1995. Benefits would increase annually due to cost-of-living adjustments, but the rise in average benefits would be partially offset by decreased Food Stamp benefits for households beginning to receive increased cash welfare, particularly Supplemental Security Income in 1994 and 1995.

These estimates are based on the operation of the Food Stamp program in Puerto Rico prior to July 1982. CBO's estimate that 1.75 million would participate is based on the 1982 average of 1.81 million people, adjusted for the national decline in Food Stamp participation since then. The drop in participation is assumed to be half as large in Puerto Rico as in the rest of the United States, where participation fell from 20.4 million in 1982 to 18.7 million in 1988, and is estimated to remain at 18.7 million in 1992.

CBO's estimate of average monthly benefits of $77 for 1992 assumes that under statehood the Puerto Rican Food Stamp program would follow national standards for maximum benefits and deductions, and that average benefits would be 17 percent larger than in the rest of the United States. Puerto Rican benefits were only 5 percent larger than national food stamp benefits in 1982. However, at that time the Puerto Rican Food Stamp program operated under a special set of lower maximum benefits and deductions that CBO assumed would not be in effect under statehood.

Medicaid. The public health program in Puerto Rico currently covers approximately 2.1 million of the iusland's 3.3 million persons. CBO assumes that the new program under Medicaid would attempt to cover a significant portion of the persons currently covered. Based on conversations with Puerto Rico's Medicaid staff, the Health Care Financing Administration (HCFA) regional office involved in the current Medicaid program, and previous published work on Puerto Rico's public health program, CBO assumed approximately 1.35 million participants annually. This estimate assumes that the health care system in Puerto Rico would respond to the new program by increasing the supply of services by fiscal year 1992. Also, Puerto Rico would receive $900 million in new Federal funds and would be required to put up $184 million in matching monies, assuming an 83 percent match required by current Medicaid law. This amount is considerably less than the $450 million the Commonwealth is currently spending, so it is possible that a state government in Puerto Rico could opt for a more extensive Medicaid program.

Medicare. Under current law, Medicare reimbursements to hospitals in Puerto Rico are determined according to provisions applicable only to such institutions located there. In general, the current level of hospital reimbursement is based on a blend of Puerto Rico's discharge-weighted average costs per case (75 percent) and the U.S. national average costs per case (25 percent). These reimbursements are otherwise similar to those received by U.S. hospitals under the prospective payment system. The per-case payments to particular hospitals are adjusted for case mix, for local wages relative to Puerto Rican wages, and for geographic location (large urban, other urban, and rural) in the same manner as in the U.S. Payments are also updated annually in a fashion similar to provisions applicable to U.S. hospitals. If Puerto Rico were to gain statehood, however, hospitals would be reimbursed according to the method used for reimbursing U.S. hospitals. Puerto Rico's hospital costs would then have negligible relevance to the resulting payment rates, which would, of course, be considerably higher than at present. The estimate is based on GAO's estimate of the increase in Part A reimbursement for 1989 attributable to this change, inflated for growth rates assumed for total hospital payments in CBO's projected baseline.

SSI. Under the statehood option, Puerto Ricans would become eligible for federal SSI January 1, 1994. The estimated increased cost over the current Aid to the Aged, Blind or Disabled (AABD) program is $600 million in 1994 and $900 million in 1995. The current AABD program costs approximately $16 million annually. The first full year estimate of $850 million in 1995 assumes average monthly participation of about 75,000 aged and 115,000 disabled (including blind) persons. Average benefits for the aged are about $260 a month and about $430 a month for the disabled. Estimated costs in 1994 are significantly lower because Puerto Ricans would not be eligible for the first three months of the fiscal year. Also, it is assumed that newly eligible participants would not move onto the SSI program immediately. Estimated administrative costs in 1994 of about $160 million are higher than in 1995 as a result of the large additional cost of processing initial claims. Estimated administrative costs for 1995 are about $35 million.

The estimated costs for SSI benefit payments in Puerto Rico were based on a 1987 study by GAO 'Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and American Samoa." This study used 1980 census data on incomes in Puerto Rico to estimate the number of people who would be eligible for SSI in Puerto Rico. Because disabled people under the age of 65 are difficult to distinguish on the census, GAO estimated only the number of eligible people aged 65 and over. The estimated average monthly SSI benefit of the latter group was approximately 20 percent higher than the average aged Federal SSI benefit in 1979. To estimate the number of disabled eligibles, we assumed the 1979 ratio of U.S. aged SSI recipients to disabled recipients would be the same in Puerto Rico. CBO used the same procedure for the disabled benefit per month relative to benefits per month for persons 65 and over. Following the GAO study, we assumed 43 percent of the estimated eligible population would have participated in 1979. This is the same estimated 43 percent SSI participation rate for aged recipients in the U.S. based on the 1980 census.

The estimated number of Puerto Rican SSI participants was adjusted by the actual growth rate in the U.S. SSI aged and disabled caseloads between 1979 and 1988. The estimated number of participants was further adjusted by CBO's baseline growth for the respective SSI populations between 1989 and 1995. The resultant change between 1979 and 1995 would be a six percent decrease in the aged population and a 65 percent increase in the disabled population. Average benefits for the aged and disabled were adjusted by the growth in U.S. average benefits between 1979 and 1988 and then adjusted further for CBO's projected growth in average benefits between 1989 and 1995. Between 1979 and 1995 the average benefits would increase by 145 percent for the aged and 160 percent for the disabled.

Administrative costs were based on SSA unit costs for workload items in the United States. Estimated costs in 1994 and 1995 reflect adjustments for October payments that get made in the previous fiscal year.

AFDC. Statehood for Puerto Rico would have a relatively small effect on federal spending in the AFDC program, as long as Puerto Rico did not raise its payment standards. CBO estimates that Federal outlays would rise by $6 million in 1992 and $70 million in 1995, as a result of a higher Federal match rate and a lifting of the spending cap. The Federal match rate would rise from 75 percent under current law to 83 percent, increasing Federal outlays by an estimated $6 million in 1992 and $10 million in 1995. Federal spending is subject to an $82 million cap under current law (including spending on AABD and on foster care and adoption assistance); lifting the cap would add nothing to Federal outlays in 1992 but an estimated $60 million in 1995.

Federal outlays resulting from statehood would rise significantly from 1992 to later years because Puerto Rico will have to implement an AFDC-Unemployed Parent (UP) program October 1, 1992, as required by the Family Support Act of 1988 (Public Law 100–485). Based on CBO estimates, about 35,000 AFDC-UP families will participate and Federal costs will amount to about $60 million a year, when the program is fully effective in fiscal year 1994 and later.

If Puerto Rico increased its AFDC payment standards, Federal costs of statehood would be significantly higher. For example, if states were to put one-half of their savings from the increased Federal match rate back into AFDC, Federal outlays would rise by another $30 million in 1995. In its 1987 study, GAO estimated that Federal outlays, as a result of statehood, would increase by $72 million a year, primarily from a doubling of AFDC payment standards. Whether Puerto Rico would raise its payment standards is uncertain. On the one hand, its standards are low and its sizable savings from expanded Medicaid coverage, along with the smaller savings in AFDC, could be used to pay for increased payment standards. On the other hand, uncertainties surrounding costs of the AFDC-UP program, increased benefits under the Nutrition Assistance Program with statehood, and concern over revenue losses under statehood would argue for caution in raising standards.

Foster Care. Extending the foster care program to Puerto Rico would cost an estimated $3 million annually, starting in 1992. This estimate assumes that 60 percent of the estimated 1,700 children in foster care in Puerto Rico would qualify for Federal reimbursements under Title IV-E of the Social Security Act, that the current $100 monthly payment rate would be increased for inflation, and that the ratio of administrative to benefit costs would be the same as in the rest of the United States.

Earned Income Tax Credit (EITC). On January 1, 1994 Puerto Rico would be subject to U.S. tax laws and as a result some may be eligible for the Earned Income Tax Credit. The estimated cost of the rebatable portion of the EITC in Puerto Rico would be $10 million in 1994 and $300 million in 1995. Because most of the EITC is paid in the form of tax refunds, the cost in 1994 is very small. Most of the cost of the EITC for calendar year 1994 fall in fiscal year 1995.

The Census Bureau has published tables showing families with children under age 18 by 1979 income level for Puerto Rico and the United States. Under current law, families with children and earnings and other income of $19,850 or less are eligible for EITC. After making adjustments for income and population growth between 1979 and 1989, there would be approximately 334,000 families eligible in Puerto Rico in 1989. This is approximately 5 percent of the U.S. families eligible in 1989. Assuming the average benefit is equal to the U.S. average benefit, the cost to the Federal Government would increase by 5 percent above current baseline estimates.

ESTIMATED FEDERAL OUTLAYS UNDER STATEHOOD

[By fiscal year in millions of dollars]

—	1992	1993	1994	1995
Food Stamps:				
Estimated Outlays	700	700	700	700
Medicaid:				
Estimated Outlays	900	1,000	1,100	1,200
Medicare:				
Estimated Outlays	60	70	80	80
SSI:				
Estimated Outlays	0	0	600	900
AFDC:				
Estimated Outlays	6	40	70	70
Foster Care:				
Estimated Outlays	*	*	*	*
Earned Income Tax Credit:				
Estimated Outlays			10	300
Total Spending:				
Estimated Outlays	1,666	1,810	2,560	3,250

INDEPENDENCE

If independence is certified, Puerto Rico would become an independent republic upon proclamation. This option would provide for a Joint Transition Commission to facilitate a smooth and equitable transfer of power. Also under independence, the bill would provide for the continuation of Federal programs for a period of time.

Commissions. S. 712 would establish a Joint Transition Commission which would oversee the transfer of power from the United States government to the newly established Puerto Rican government. It is anticipated that the Commission would need to establish a number of task forces to handle various aspects of the transition. The costs of this Commission would be borne evenly between the U.S. and Puerto Rican governments. CBO estimates the cost to the Federal Government would be between $2 million and $3 million annually beginning in fiscal year 1992.

Federal Programs. S. 712 would provide for the continuation of all Federal programs until the end of the fiscal year in which independence is proclaimed. At such time, a grant would be paid annually to the Republic of Puerto Rico in an amount equal to the total amount of grants, programs, and services provided by the Federal Government in such fiscal year through the ninth year following certification of the referendum.

In addition, the bill would allow Puerto Rico to request renewal or continuation of any existing contractual obligations, provided that Puerto Rico agrees that the cost of such renewal or continuation shall be deducted from the annual grant. Also, all Federal pension programs and Social Security benefits shall continue as provided by U.S. law.

The bill does not address the date of proclamation, but it does state that the procedures for implementing the status option certified shall go into effect on October 1, 1991. The bill then outlines the procedures for implementing independence. The procedures are: (1) election of delegates to a constitutional convention, (2) development and adoption of the constitution, (3) ratification of the constitution, (4) election of officers of the Republic, and then (5) proclamation. The length of time any one of these events would take is uncertain. While most of these procedures have a time limit specified in the bill, the most significant one—the development and adoption of the constitution—does not. The time required to adopt a constitution could range from six months to several years. Based upon discussions with people in Puerto Rico and the knowledge that the current constitution is republican in form and in conformity with the constitution of the United States and has many of the qualifications specified in S. 712, CBO has estimated that a constitution could be adopted within one year. Based upon this assumption and other information in the bill, CBO assumes independence would be proclaimed in fiscal year 1993.

CBO estimates the total amount of grants, programs and services for Puerto Rico in fiscal year 1993 will be $3.8 billion. This estimate was developed by excluding

Social Security, other Federal pension programs, salaries and wages, and procurement from the 1988 Federal expenditures in Puerto Rico and adjusting for inflation.

The bill specifies that Social Security and other Federal pension programs would continue and therefore would not be included in the block grant. The bill also specifies—subject to negotiation—the continued U.S. operation and use of military installations; therefore, no defense expenditures in Puerto Rico would be included in the block grant. The savings to the Federal Government for fiscal years 1994 and 1995 would be the difference between the 1993 base amount and the 1993 grant adjusted for inflation through 1995. The estimated savings would be $0.1 billion and $0.3 billion in fiscal years 1994 and 1995 respectively. The breakdown between direct spending and authorization levels is difficult to determine, and the bill is unclear if the grant would be an entitlement or not.

ENHANCED COMMONWEALTH STATUS

If enhanced commonwealth is certified, the relationship between Puerto Rico and the United States remains essentially the same. Under this option, the bill would establish a Caribbean Basin passport office and a Senate Liaison office. The bill also would provide for the consolidation of Federal grant-in-aid programs.

Passport Office. S. 712 would require the Federal Government to establish a passport office in Puerto Rico for the Caribbean Basin. The State Department estimates the passport office will receive 50,000 applications per year. The cost estimate includes a one time $2.5 million cost to set-up, equip, and train office staff for the office. The annual operating expenses would be about $1 million annually. This estimate assumes 17 full-time Federal employees.

Liaison Office. S. 712 would establish an Office of Senate Liaison for the Commonwealth of Puerto Rico to facilitate communications between the U.S. Senate and the Commonwealth. The bill would authorize an annual appropriation of $600,000 for salaries and $56,000 for office expenses. This estimate assumes that the Senate Liaison would be appointed by January 1992. CBO assumes that the entire appropriation will be spent in each year.

Federal Programs. If enhanced commonwealth status is elected, section 501 of Public Law 95-134—Authorization, Appropriation-U.S. Territories—would apply to Puerto Rico. Section 501 allows any government agency to consolidate grants-in-aid other than direct payments to individuals for any fiscal year(s). The grant is not to be less than the sum of all grants to which Puerto Rico is otherwise entitled. The grant is to be expended for the programs and purposes authorized, but Puerto Rico will be allowed to determine the proportion of the funds granted which shall be allocated to such programs and purposes. Each government agency shall publish the method by which Puerto Rico shall submit an application for a consolidated grant in the Federal register. The agency also may waive the requirement for an application with respect to a consolidated grant. CBO estimates there will be no additional costs for these programs with enactment of this bill.

The CBO assumes that all authorizations are fully appropriated at the beginning of each fiscal year. Outlays are estimated using spendout rates computed by CBO on the basis of recent program data.

These estimates have been developed with the assistance of the General Accounting Office and the Congressional Research Service. Much of the work in this estimate is based on a report the General Accounting Office published in 1987—Welfare and Taxes: Extending Benefits and Taxes to Puerto Rico, Virgin Islands, Guam, and the American Samoa. In addition, the General Accounting Office made available the back up materials developed while preparing the report. These materials were helpful in preparing these estimates. The Congressional Research Service provided assistance in developing the Earned Income Tax Credit estimate and provided invaluable background information on Federal programs in Puerto Rico. Finally, the government of Puerto Rico has provided valuable information on the possible costs of S. 712.

6. ESTIMATED COST TO STATE AND LOCAL GOVERNMENTS:

The costs to state and local governments would vary considerably depending upon which status option is certified. Under Enhanced Commonwealth, there would be essentially no change; therefore, CBO estimates there would be no cost the state and local governments. Under Independence, there would be savings to the Federal Government as indicated above. However, it is unclear to what extent Puerto Rico would pick up the difference in program spending.

Under Statehood, Puerto Rico would incur significant savings in some entitlement programs The AABD program would be replaced with the federally funded SSA program, and Puerto Rico would save $5 million annually. Currently, Puerto Rico spends $450 million on health care, and under Statehood and the extension of Medicaid, Puerto Rico would spend $184 million on health care for a net savings of $266 million in benefit payments in fiscal year 1992. The savings would be $245 million, $225 million, and $204 million in fiscal years 1993, 1994, and 1995. Puerto Rico would save $6 million, $40 million, $70 million and $70 million in 1992, 1993, 1994 and 1995 respectively on the AFDC program. These AFDC savings would result from provisions in the bill that increase the Federal match rate and eliminate the cap on Federal funds.

Extending the Food Stamp program to Puerto Rico would increase administrative costs to the island, due to increased costs for eligibility certification, work programs and quality control activities. The net increase would be approximately $75 million with higher costs expected if Puerto Rico opts to distribute coupons rather than cash.

7. ESTIMATE COMPARISON: None
8. PREVIOUS CBO ESTIMATE:

On September 6, 1989, CBO prepared an estimate of S. 712, The Puerto Rico Status Referendum Act. This estimate revises the independence option in the following ways. In the original estimate, CBO assumed the amount of the block grant would be determined at the end of fiscal year 1991 and the savings to the Federal Government would begin in fiscal year 1992. In this estimate, the block grant is determined at the end of fiscal year 1993 and the savings to the Federal Government begin in fiscal year 1994. Also, in the original estimate, the block grant contained Federal expenditures in Puerto Rico for Social Security benefits, Federal pensions, defense salaries and procurement. In this estimate, we removed these amounts from the calculation on the block grant.

9. ESTIMATE PREPARED BY:

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10. ESTIMATE APPROVED BY:

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Prepared Statement of Senator Paul Simon

Good morning, Mr. Chairman. I am pleased to come before the Senate Finance Committee today to speak in strong support of the Puerto Rico plebiscite bill, S. 712. I have joined our colleagues, J. Bennett Johnston and James McClure, the Chairman and ranking member respectively of the Energy and Commerce Committee, to cosponsor this important legislation for the future status of Puerto Rico. I am greatly appreciative that the Finance Committee has agreed to hold hearings on this legislation prior to the end of the session.

As may be aware, I believe in statehood for Puerto Rico. If statehood is the ultimate status that the Puerto Rican people desire, then Congress ought to act on that message. Every President since Harry Truman has endorsed the principle that the United States will elicit and respect the will of the people of Puerto Rico on this vitally important subject. The plebiscite bill before this committee gives Puerto Ricans the full opportunity to express their will, be it for commonwealth status, statehood or independence.

This choice is one that belongs in the hands of the people of Puerto Rico. I have made known for many years my support for statehood because I believe that it is the only status under which Puerto Ricans will be treated as full United States citizens. Nonetheless, it' is more important to me that the choice of the Puerto Rican people determine the outcome.

The Puerto Rico status question is of critical importance, not just on the island of Puerto Rico but strikes close to many core principles of the nation. At present, the people of Puerto Rico are treated as second-class citizens. We recently celebrated the 72nd anniversary of U.S. citizenship for Puerto Ricans granted by the enactment of the 1917 Act to provide for a civil government for Puerto Rico. But that citizenship is still second-class citizenship and enhancing the current status will not cure that defect.

Let me share with the Committee some of the ways in which Puerto Rico is shortchanged. First, we have no colleagues in the United States Senate representing Puerto Rico. On any issue that comes to the floor of the United States Senate, the people of Puerto Rico have views. But Americans living in Puerto Rico have no direct say on the Senate floor whether that be on housing, employment, defense, foreign policy or any other issue. Second, in the House of Representatives, the 3.3 million Puerto Ricans have only one non-voting representative. If Puerto Rico were a state, it would have six or seven voting representatives. Third, Puerto Ricans on the island have no electoral votes for President or Vice President of their United States. They are American citizens but are virtually shut out of representation in these two branches of government.

What does that shortcoming translate into in every day terms? I mentioned that Puerto Rico has 3.3 million residents. This is roughly equal to the population of each of the states of Arizona, Colorado, Connecticut, Kentucky, Oklahoma and South Carolina. The average Federal expenditure for these states is $10.3 billion. Yet the Federal expenditures for Puerto Rico are just $5.8 billion. The Puerto Rico shortfall is $4.5 billion and Puerto Rico's population is far more in need than the populations of these states. Similarly, per capita Federal expenditures nationally are $3252 per person. But Puerto Ricans only get $1786 in per capita expenditures. There are a number of other Federal programs in which American citizens in Puerto Rico are treated less favorably than other Americans and there are programs from which Puerto Rico is totally excluded.

The sons of Puerto Rico have fought and died for this country in every battle waged by our military. 65,000 Puerto Ricans served during World War II. 61,000 served in Korea. In Korea, Puerto Rico had one casualty for every 600 inhabitants as compared to one casualty for every 1125 inhabitants on the mainland. The legendary 65th Infantry Regiment composed of Puerto Ricans distinguished itself in almost all of the major battles in the Korean Conflict and received numerous Presidential commendations. It is said that Puerto Ricans benefit today by not having to pay Federal taxes. The reality is that they have paid the highest tax of all in defense of our nation and statehood will give them the respect and fair treatment they deserve.

Let me conclude, Mr. Chairman, by bringing to your attention a report prepared by the accounting firm of Price, Waterhouse. The report documents the value of Federal grants made available to states at the time of their admission. Translated into 1989 dollars, the average state received the equivalent of $48,169 per person. My own state of Illinois received $860,864 per person. Obviously, Puerto Ricans will be receiving nowhere near that amount nor is anyone proposing that they do. Nonetheless, it is important that this historical context be brought into the debate when it is suggested that the legislation as approved by the Energy Committee somehow unfairly tilts toward one status over the others.

Every status option has it pluses and minuses. Some can be readily quantified and some are not so easily quantified. Statehood brings with it increased and fair participation in federal programs and full and appropriate imposition of Federal income taxes. S. 712 is a balanced bill and a timely one. I thank the Committee for the opportunity to speak in favor of S. 712 this morning.

PREPARED STATEMENT OF ARNOLD R. TOMPKINS

Mr. Chairman and Members of the Committee: I appreciate the opportunity to appear before the committee to provide information on the operation of the Department of Health and Human Services (HHS) programs in Puerto Rico and on the impact of S. 712 on those programs. We agree that it is important to provide an opportunity for the people of Puerto Rico to choose their future relationship with the United States and believe that the options set out in the bill. are, in general, workable. However, we have certain concerns which I will discuss.

This Department provides approximately $2.6 billion per year either directly to or on behalf of residents of Puerto Rico or in payments to the Government of Puerto Rico. Most of this—$2 billion—is for Social Security benefits.

Each of the three options set out in S. 712—commonwealth, statehood, and independence-would have varying effects on the funding and operation of HHS programs in Puerto Rico. I will first summarize how each of the three options of S. 712

addresses HHS programs and then briefly discuss the specific effects of the bill on our programs.

EFFECTS OF COMMONWEALTH, STATEHOOD, AND INDEPENDENCE

Commonwealth

Commonwealth status as provided for in S. 712 would have little direct effect on HHS programs. The most significant change is related to the bill's provision allowing Federal agencies to consolidate certain financial assistance programs. We do not anticipate that the consolidation provision—as currently drafted and as we apply it to other insular areas—would allow consolidation of entitlement programs.

Statehood

Statehood would make three significant changes to operation of HHS programs in Puerto Rico. First, it would substitute the Supplemental Security Income program (SSI)—which is 100 percent Federally funded, open-ended, and has far higher eligibility and benefit levels—for the current Federally assisted program for the aged, blind, and disabled, for which Federal payments to Puerto Rico are limited by statute.

Second, statehood would increase Federal funding for several other HHS entitlement programs—primarily Aid to Families with Dependent Children (AFDC) and Medicaid.

The aggregate costs to the Federal Government for the HHS portion of the statehood option could be an additional $1.5 billion per year or more in FY 1995. This estimate is preliminary as the actual costs would depend on how Puerto Rico would modify its AFDC and Medicaid programs. Nevertheless, the Administration is ready to accept the budgetary effects.

Statehood would have little effect on Social Security. It could, however, substantially increase the cost of Medicare in Puerto Rico unless the current method of reimbursing Puerto Rican hospitals is maintained.

We believe that if Puerto Rico chooses to become a state, the new state and its citizens should be treated similarly to other states and their citizens.

Independence

The independence option would have two primary effects on HHS programs. First, it would remove HHS from involvement in program administration by providing current program funds to Puerto Rico through a block grant for nine years.

Second, it would lead to new Social Security and Medicare systems for the new nation The current Social Security system would continue for five years; Puerto Rico would need to develop its own social insurance programs which would need to be coordinated with the U.S. systems to protect the rights of beneficiaries and workers in Puerto Rico.

Let me now discuss in more detail what I see as the major implications of S. 712 on HHS programs.

MAJOR IMPLICATIONS OF S. 712 FOR HHS PROGRAMS

1. INDEPENDENCE: TRANSITION TO PUERTO RICAN SOCIAL SECURITY AND MEDICARE SYSTEMS

Independence would substantially change the operation and responsibilities for Social Security and Medicare programs in Puerto Rico. The transition to the newly developed Puerto Rican systems could be complex.

Currently, Puerto Rico employers and employees are covered by Social Security—old age and survivors and disability insurance—in the same manner as employers and employees in the 50 states. Under statehood or commonwealth status, there would be no substantial change in this program. However, independence would have major implications for workers and future Social Security beneficiaries and for the Social Security trust funds.

Under the Medicare program, employers and employees in Puerto Rico, as in the United States, contribute to the hospital insurance trust fund through the payroll tax—currently set at 1.45% of covered wages. Beneficiaries also pay premiums into the supplemental medical insurance trust fund for physicians' services. Beginning in 1990, they will also be subject to the premiums under the Medicare Catastrophic Coverage Act.

S. 712 recognizes the complexity of the changes for both Social Security and Medicare and establishes a Commission to address them. We support this approach. The Commission would need to consider how to treat current beneficiaries and those who are about to become eligible and how to assure that equity, financial, and administrative issues are dealt with in the most appropriate manner. Subsequently, HHS could negotiate a totalization agreement for Social Security, similar to ones we have with eleven other countries.

2. STATEHOOD: PROVIDING SSI TO THE AGED, BLIND AND DISABLED UNDER STATEHOOD

The statehood option under S. 712 would substitute SSI for the current program providing assistance to low-income aged, blind, and disabled persons. The current program-Aid to the Aged, Blind and Disabled (AABD)—is jointly funded by the Federal government and the Commonwealth, while SSI is Federally funded and provides benefits, set by statute, directly to low-income aged, blind, and disabled persons.

The replacement of the AABD program with SSI has significant budgetary consequences. The Federal share of the current program in Puerto Rico is about $18 million, while the cost of full extension of SSI would be approximately $800 million for the first full year of implementation—based on estimated 1995 benefit levels-and would increase in subsequent years due to the indexing of benefits.

Extension of SSI would constitute' a major change for the individuals affected and the communities of Puerto Rico—with potentially significant effects on the Puerto Rican economy and social institutions. Under SSI, benefit levels are nationally uniform and in CY 1989 are set at $553 per month for a couple with no other income. In contrast, the benefit level set by Puerto Rico under the current AABD program for the same couple is $64 per month plus 50 percent of actual shelter costs. Thus, there would be a dramatic increase in benefits. Furthermore, the eligibility rules set by Puerto Rico entitle about 41,000 persons to payments under the current program, while the number of people eligible for SSI would be about 185,000—an increase of about 144,000 beneficiaries.

S. 712 provides a mechanism for addressing the most appropriate manner of extending Federal programs to Puerto Rico through establishment of a Commission on Federal Laws. We believe that such a Commission should consider how the SSI program should be implemented in Puerto Rico. We also suggest the Commission's recommendations be made as early as possible.

3. STATEHOOD: MEDICARE PAYMENTS TO PUERTO RICO UNDER STATEHOOD

Payments for hospital, physician, and other Medicare services are made to health care providers in Puerto Rico substantially as they are for hospital and other health providers in the United States. However, there is one major difference. Under Medicare's prospective payment system, the rate of reimbursement for hospitals in Puerto Rico is different than for hospitals in the 50 states. Whereas the latter are reimbursed at a national rate, Puerto Rican hospitals are reimbursed at a blended rate based 25% on the national rate and 75% on the local rate in Puerto Rico. This is indexed to adjust for the significantly lower cost of providing medical care in Puerto Rico.

If Puerto Rican hospitals were to be paid as the hospitals in states are now paid—that is at a fully national rate—payments would be 36% higher than current payments. The effect would be to increase the Federal costs by approximately $48 million Since hospital costs are substantially lower in Puerto Rico, this could result in windfall to Puerto Rican hospitals.

S. 712 provides that "reimbursement under Medicare shall not exceed the actual costs of providing equivalent health care to the levels of care provided in the several contiguous states." How to implement this provision is unclear. If we pay at rates equivalent to what we pay providers in the U.S. we would overpay hospitals in Puerto Rico. If we pay "actual costs," this would be inconsistent with the prospective payment approach which is designed to provide incentives to control costs.

4. STATEHOOD: BUDGETARY CONSEQUENCES OF STATE-LIKE TREATMENT OF ELEMENT PROGRAMS

Statehood would remove current limitations on Puerto Rico's participation in AFDC, Medicaid, Foster Care, and the Social Services Block Grant.

Aid to Families with Dependent Children

Puerto Rico participates in the Aid to Families with Dependent Children (AFDC) program and the related Emergency Assistance program. As with the 50 states, Puerto Rico establishes its AFDC benefit levels, and the Federal Government provides matching funds established in law as an entitlement to participating governments. In Puerto Rico's case, the matching rate is statutorily set at 75%, while matching rates for the states can go as high as 83%.

A second difference from state programs is that, while Federal matching for state program expenditures is "open ended," Federal matching for Puerto Rico is limited statutorily to $82 million for AFDC, AABD, and Foster Care. We estimate that Puerto Rico will be at its funding ceiling for these programs in FY 1990 and beyond. Puerto Rico currently spends about $78 million for AFDC and receives $64 million in Federal matching funds.

Under the statehood option, the ceiling would be removed and expenditures would be matched at a higher rate—83%. Thus, even without changing benefits and eligibility rules, Federal reimbursement for the basic program would increase by about $6 million An additional $64 million in Federal funding would be required as a result of changes Puerto Rico would have to make to comply with the AFDC-Unemployed Parent requirements of the Family Support Act. In addition, with increased matching and no cap on the expenditures, if Puerto Rico decided to increase its payment standard, this also would increase Federal reimbursement. Although payment standards are low and Puerto Rico could raise its benefit levels, increased costs associated with implementing the AFDC-UP program may preclude Puerto Rico from raising payment standards.

Of course, the interrelationships between AFDC, SSI and Medicaid will influence how Puerto Rico structures its AFDC program as well as our estimates of participation and costs for AFDC and the other two programs.

Medicaid

Federal financing of the Medicaid program is similar in concept to AFDC in that, by using a formula based on per capita income in each state, it reimburses states from 50 to 83 percent of their medical expenditures for eligible persons. Puerto Rico's matching rate is limited statutorily to 50 percent and total Federal matching of Puerto Rican medical and administrative expenditures is capped at $79 million for FY 1990 and beyond.

Puerto Rico reported Medicaid expenditures for FY 1988 of about $129 million for medical services and $18 million for administration The reported expenditures entitled Puerto Rico to reimbursement of $73.4 million allowed under the ceiling. The cap was increased to $79 million for FY 1989.

Under statehood, the cap would be removed and the matching rate would rise to 83%—the maximum allowable rates for states. Even without any changes in the services provided under its Medicaid program, Puerto Rico would be entitled-based on the expenditures for FY 1988—to at least an additional $55 million. However, Puerto Rico would almost certainly make changes in its Medicaid program. These would likely include: reporting more of its medical expenditures (the incentive for full reporting is minimal given the ceiling); covering the additional 144,000 persons made eligible as SSI beneficiaries; and expansion of Medicaid-covered services.

The variety of possible changes to the Medicaid program in Puerto Rico make it difficult to estimate the budgetary impact or ultimate composition of the program under statehood. However, we roughly estimate an increase for FY 1992 of $300 million and $1.1 billion by FY 1996 if the ceiling were removed.

Foster Care and Adoption Assistance

The Foster Care and Adoption Assistance programs provide Federal matching on a statutory entitlement basis of state expenditures for children removed from AFDC families into foster care or adoptive placements. Puerto Rico is eligible to participate in the program, but does not do so because, under current law, the AFDC, AABD, and Foster Care programs are subject to the statutory ceiling I mentioned earlier and Puerto Rico uses virtually all the funds under the cap for its AFDC and AABD programs. Under statehood, Puerto Rico may participate in this program.

CONCLUSION

S. 712 provides the people of Puerto Rico with a very important choice. In general, the bill is structured to make the choice clear and meaningful. However, as I indicated, we have concerns about some of the bill's provisions. We will continue to work with the Committees of the Congress to ensure that legislation achieves its intended purposes 19 an equitable manner.

Thank you for this opportunity. I will be happy to answer any questions you may have and provide any additional information you may require.

PREPARED STATEMENT OF LAWRENCE H. TRIBE

Mr. Chairman and Members of the Committee:

My name is Laurence Tribe. I am Tyler Professor of Constitutional Law at Harvard Law School, where I have taught for 20 years. I appreciate the Committee's invitation to testify before you today.

I wish to make one point at the outset of my testimony that I believe distinguishes it from testimony heard by your colleagues on the Senate Energy and Natural Resources Committee. While I have been retained by the Commonwealth of Puerto Rico through its lead counsel in Washington, Richard Copaken of Covington & Burling, to consult and provide objective expert advice on constitutional issues, I made it clear from the outset that I would not undertake this assignment as an advocate and would have to retain the freedom to express my personal views—*whether or not* those views coincided with the judgment or wishes of the Governor of Puerto Rico or the political party he leads. That understanding has prevailed, and indeed, the Governor structured all of the Commonwealth proposals that came before the Energy Committee and those that are before you now to comply fully with all of the constitutional considerations I have raised. I have not altered my views in the slightest to act as an advocate for any Puerto Rican political party or position.

In short, every word I have put my name to in this process—my letter of June 13, 1989, on the permanency-of-citizenship issue; the 19-page memorandum of law on the Tax Uniformity Clause dated July 18, 1989; the July 19 cover letter for that memorandum; my lengthy letter of August 31, 1989, on S. 712 as reported by the Energy Committee; and finally, my testimony before you today—represents my own independent judgment as a scholar of constitutional law. What I have written and what I am telling you today would not change if I were not a consultant in this process.

It may be that Professor Gewirtz, in his testimony of June 2 before the Energy Committee, understood his role differently—as that of a vigorous advocate free to advance a client's views even though they might not be his own. I cannot otherwise account for the testimony he submitted and have every reason to believe that, in a different setting, Professor Gewirtz would come to the same conclusions I have.

In any event, I believe that Professor Gewirtz's June 2 testimony—to which I unfortunately have not had the opportunity to respond in person until today—led the Energy Committee to make a critical mistake, though an understandable one under the circumstances. As a result, S. 712 as reported is needlessly vulnerable to judicial reversal or injunction. If the bill as reported is enacted into law, the status referendum in Puerto Rico provided for in the bill may never be held, or its results may be judicially overturned, because the statehood provisions of the bill violate the Constitution of the United States.

My testimony today concerns the tax treatment that would be accorded a State of Puerto Rico under S. 712 as reported, in the event statehood is chosen in the referendum for which the bill provides. I see two fundamental problems with this tax treatment, and two basic solutions. In overview, these are as follows. The first fundamental problem is that the bill's continuation into statehood of the tax advantages permitted at present for the *Commonwealth* of Puerto Rico because of its unique non-state status violates the Tax Uniformity Clause of the Constitution, which mandates that Federal income taxes be uniform throughout the states of the United States. The second fundamental problem is that these tax provisions also transgress the Constitution's *equal footing* doctrine, which requires Congress to treat new states on the same footing as it treats states already in the Union.

The two basic solutions that I will describe would both achieve the same desired goal of a smooth transition to statehood, but in a fashion that would be constitutional, that would not violate the principle of equal footing, and that would have added side benefits as well. First, Congress may simply *defer* the moment when Puerto Rico would become a state until after the tax advantages presently accorded to Puerto Rico as a *commonwealth* had been completely eliminated. Second, Congress unquestionably possesses the power to ease Puerto Rico's transition to statehood by directing its appropriations wherever they are needed under the Spending Clause—a power that is not subject to any constitutional constraint such as the Tax Uniformity Clause.

The Tax Uniformity Clause of the United States Constitution, Article I, Section 8, Clause I, commands that all "Duties. Imports and Excises shall be uniform throughout the United States." As I explain in my memorandum of law, the term "duties, imposts and excises" includes Federal income taxes. What this means is that Congress in imposing Federal income taxes cannot single out any state of the United States for preference or disfavor. The Framers' debates show that it was just this kind of favoritism or regionalism that the Clause was designed to prevent. Because the power to tax is "essentially a power to destroy," *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316, 391 (1819), the constitutional convention expressly prohibited Congress from using something like the Federal income tax to single out particular states or groups of states for disparate treatment.

I should tell you that Professor Gewirtz in his testimony before the Energy Committee argued that it is still a debated proposition whether the Federal income tax is even subject to the Uniformity Clause. In fact, however, it is clear for a number of reasons that there is no *real* debate on this issue. As I point out in my memorandum of law, a 1916 Supreme Court case called *Brushaber* v. *Union Pacific Railroad Co.*, 240 U.S. 1, 18-19 (1916), put to rest any doubt on that score. So any attempts to cloud the issue notwithstanding, it is clear that Federal income taxes, including those at issue in S. 712 as reported, *are* subject to the Uniformity Clause.

I should also point out that Professor Gewirtz draws exactly the wrong lesson from the fact that the Supreme Court has never relied on the Tax Uniformity Clause to invalidate a congressional tax provision. The Uniformity Clause has been a constitutional success story precisely because it is a *clear* and readily understood restriction on congressional power. As such, it has had exactly the effect that the Framers hoped it would—discouraging preferential or prejudicial tax treatment of any state by Congress, and making litigation on the subject largely unnecessary. The story of the Tax Uniformity Clause is hardly one of impotence; it is of powerful, effective *deterrence*.

What, then, does the applicability of the Uniformity Clause mean for S. 712? In the event statehood were chosen in the referendum, the bill as reported would continue Sections 936 and 933 of the tax code into statehood for "phase-out" periods of 6-1/2 and 2-1/2 years, respectively. The thrust of Professor Gewirtz's testimony before the Energy Committee was that this could be done—that Sections 936 and 933 as presently structured can be made to survive into statehood.

That view is incorrect. The Tax Uniformity Clause flatly prohibits Congress from providing the same intentional targeted tax benefits to a State of Puerto Rico that it now constitutionally provides to the Commonwealth of Puerto Rico. Briefly, Section 936 exempts from Federal tax the income *earned in Puerto Rico* by *U.S. corporations;* Section 933 exempts from the *personal* income tax all income from *Puerto Rican sources*. Sections 936 and 933 were enacted avowedly *to discriminate* in favor of the Commonwealth of Puerto Rico, and the former in particular was intended explicitly to aid in building a productive economy. Sections 936 and 933 are essential tools of economic development that have been very effective in achieving that aim. These tax advantages have been wise U.S. policy toward an associated Commonwealth in the Caribbean. But if Puerto Rico becomes a state, they would become *exactly* the kind of naked political preference for one state over others that is barred by the Tax Uniformity Clause. S. 712 as reported is unconstitutional.

Apparently, the view prevailed in the Energy Committee that Congress's constitutional power to admit new states gives it the power to smooth Puerto Rico's transition into statehood by continuing Sections 936 and 933—naked preferences that they are—into statehood if that option is chosen in the referendum. But the worthiness of that end does not excuse the unconstitutionality of the chosen means—especially where there are constitutional means to achieve the same goal. The broad, unquestioned constitutional power to admit new states does *not* confer a license to violate the clear constitutional command of the Tax Uniformity Clause.

Professor Gewirtz's June 2 testimony, apparently accepted by the Energy Committee, was that, "regardless of what the Uniformity Clause might restrict," it is somehow "*intersected by*" Congress's authority to admit new states into the Union under Article IV in a way that would allow Congress to simply ignore the Uniformity Clause. (Gewirtz Testimony at p. 20) (emphasis added). This is an extraordinary claim, and I know of no legal authority that would legitimately support it. Legislation that violates a constitutional prohibition is not rescued by being enacted under the guise of, or in some sort of "intersection with," a distinct affirmative source of congressional authority—however legitimate that authority might be in a different context.

Put differently, a state of affairs either offends our Constitution or it does not. Thinking that the Tax Uniformity Clause is not violated because the provisions that violate it only do so for a "temporary transitional period" of 6-1/2 years is like thinking that a woman isn't pregnant because her condition will be "phased out" in 9 months.

One fundamental problem with S. 712, then, is that it is unconstitutional under the Tax Uniformity Clause. A second fundamental problem is that it violates the equal footing doctrine.

Congress cannot do something—even something temporary—to a new state that the Constitution does not empower it to do to states generally. That is the holding and the lesson of *Coyle* v. *Smith*, 221 U.S. 559 (1911), a case that Professor Gewirtz referred to in another part of his June 2 testimony as "a bedrock." In admitting Oklahoma to the Union, Congress attempted to dictate where Oklahoma's state capital should be for just 6-1/2 years after statehood—coincidentally, the very same transition period found in the bill before you. The Supreme Court said Congress could not do so, holding that Oklahoma was entitled to be on an "equal footing" with the other states—as free as older states to choose where its capital would be—immediately on becoming a state, not after some transition or "phasing in" period.

There is no sustainable argument for the view that the "equal footing" rule of *Coyle* cuts only one way. Under that rule, Congress cannot do something unconstitutional to help a new state enter the Union on a "*more*" than equal footing, just as it cannot do something unconstitutional to force a new state to enter the Union on a "*less*" than equal footing. Any other rule, any artificial "one-way" reading of *Coyle*, would be unprincipled in theory and difficult if not impossible to administer in practice. This is particularly so since one can readily imagine cases where it would be exceedingly hard to tell which transition provisions amount to benefits *for* the new state, and which amount to burdens *upon* it.

For example, in admitting a new state where much-needed resources were in the hands of private owners, could Congress temporarily exempt the state from the constitutional requirement that just compensation be paid to citizens whose property is taken? It is far from clear whether such an exemption from a constitutional requirement would be a benefit to, or burden on, the new state. (And indeed, the 1787 Constitution imposed no such requirement on the states of the Union.) My point is that Congress cannot condition the admission of new states on standards that are different from those it may *constitutionally* impose on existing states—whether these different standards are, on balance, seen as beneficial or burdensome. If the Uniformity Clause means that Congress cannot disfavor Mississippi relative to California by giving California a special preference in Federal income taxes—and that is *exactly* what the Clause means—then *Coyle* tells us that Congress also cannot use the constitutionally prohibited tool of non-uniform Federal income tax treatment to disfavor Mississippi relative to a new state of Puerto Rico. In short, the Supreme Court would have to overrule its bedrock decision in *Coyle* v. *Smith* before Professor Gewirtz's advice to the Energy Committee—or the provisions of S. 712 in which that advice apparently was taken—could stand.

The two fundamental problems with S. 712 as reported—its violation of the Tax Uniformity Clause and of the equal footing rule of *Coyle*—have solutions that are practical, attainable, and anything but exotic. I will sketch these briefly.

Clearly, Congress can use its power under the Spending Clause to direct grants of assistance to Puerto Rico so as to fiscally smooth its transition to statehood. This would entail no equal footing problem under *Coyle* because the means used to favor the State of Puerto Rico—use of the Spending Power to single out one state for help over others—would themselves be perfectly constitutional as applied to any existing state of the Union.

I understand that new congressional spending as such may be unpalatable. I therefore mention a constitutional alternative *tax treatment* that I have written about in connection with S. 712. That is simply to defer making Puerto Rico a state until after the last remnants of its commonwealth tax preferences have been eliminated. This elimination can be the kind of gradual phase-out found in S. 712, or it can be a complete elimination of Sections 936 and 933 in a single moment. The key is simply that, as a matter of constitutional law, *statehood cannot begin until the tax preferences end.*

Speaking now only of tax treatment, and not of appropriations under the Spending Clause, I see three logical possibilities. The first is what we have now in S. 712 as reported; the latter two, by contrast, would both obey the constitutional rule that statehood cannot begin until the tax preferences end. The first possibility, "*front-loading*," as the Energy Committee's report on S. 712 called it, provides for the attainment of statehood (along with entitlement to full Federal benefits for Puerto Rico) *before* the commonwealth tax preferences are phased out. The second possibility, call it "*deferred statehood*," phases out the tax preferences while they are still constitutional—that is, before Puerto Rico becomes a state. The third possibility, call it "*one fell swoop*," complies with the Constitution not by postponing statehood, but by *accelerating the repeal of tax preferences* so that these preferences would not intrude into statehood.

You can see that the second and third approaches do the same thing in different ways. The key is that neither crosses the bright constitutional line between Federal income tax preferences and statehood. (You can also see, by the way, that while the "one fell swoop" approach is constitutional and eliminates the front-loading problem, it does not smooth the transition into statehood. But because it makes the onset of full federal benefits simultaneous with the loss of tax advantages, it is still closer to revenue neutrality than the unconstitutional, front-loaded, net outflow approach of S. 712 as reported.)

It seems to me that either of the constitutional *tax* approaches I have sketched here would have the added benefit of presenting to the Puerto Rican people choices in the referendum that are *more clear* and *more fair* than the present, "front-loaded" statehood provisions of the bill. S. 712 as reported holds out to the voters of Puerto Rico the false promise that they can have both statehood *and* the tax advantages of commonwealth, at the same time. Our Constitution's Tax Uniformity Clause, and the equal footing rule of *Coyle* v. *Smith*, clearly say that this cannot be. Both of the alternative tax approaches avoid these problems. And the "deferred statehood" approach would lessen and legitimately defer the net costs to the United States of Puerto Rican statehood—to a time when the United States may be better able to absorb those costs.

(Incidentally, under either of the alternative tax approaches, Congress need not be concerned that the so-called "incorporation" doctrine would subject Puerto Rico to the requirements of the Tax Uniformity Clause prior to the actual attainment of statehood. As I detail in my August 31 letter, as long as Puerto Rico is not yet a state, a provision in the law expressing Congress's intent that Puerto Rico not be considered "incorporated" as part of the United States during the pre-statehood transition would clearly be controlling.)

One final point. I know that scholars of constitutional law can seem like naysayers. That is why I have discussed not only constitutional problems, but also their solutions. I am also aware that it may seem far-fetched that something as sensible and innocuous-seeming as a phasing out, during the first few years of statehood, of tax provisions already permitted for the Commonwealth of Puerto Rico should be prohibited by the Constitution of the United States. But the delegation of power in the first Gramm-Rudman compromise that was overturned by the Supreme Court seemed to many to be just as sensible and non-problematic when it was enacted. Between that situation and this one there is this difference: the constitutional tax alternatives proposed here are as effective as the unconstitutional provisions of S. 712 that they would replace. But there is also this important similarity: Sometimes a constitutional prohibition is so clear that any violation of it in legislation, even an innocent-seeming one, invites judicial upset of that legislation.

Even if you do not agree with me that the courts would find unconstitutional the statehood tax provisions of S. 712 as reported, I hope you will recognize that the level of *risk* that the referendum would be enjoined or overturned because of these provisions is unacceptable—and that taking such a risk is especially unjustified where there are constitutionally sound, effective means of achieving the same result.

I would be happy to respond to your questions.

Attachment.

COVINGTON & BURLING,
Washington, DC, July 20, 1989.

Hon. BENNETT JOHNSTON,
Hon. JAMES MCCLURE,
U.S. Senate

Dear Senators Johnston and McClure: Enclosed for your information is a letter prepared by Professor Laurence H. Tribe, Tyler Professor of Constitutional Law of Harvard University Law School, together with a Memorandum of Law jointly prepared by Professor Tribe and our law firm, analyzing the Tax Uniformity Clause of the United States Constitution as it applies to the current consideration of S. 712.

I especially draw your attention to Professor Tribe's and our conclusion regarding the constitutional infirmity that would inhere in any purported legislative transitional phase out of section 936 in the event Puerto Rico were to become a state of the Union. The Supreme Court's decision in *Coyle* v. *Smith*, 221 US 559 (1911) struck down a transitional provision Congress enacted as part of the enabling statute pursuant to which Oklahoma became a state of the Union even though the condition barred by the Constitution that Congress sought to impose as a temporary transitional measure was scheduled to last only 6-1/2 years. That section of the Memorandum begins at page 14. In short, that which is prohibited by the Constitution is not made more acceptable by the temporary transitional nature of its imposition. The people of Puerto Rico should not be put to a choice that purports to assure them of more than the courts are likely to permit, especially in regard to the most fundamental bedrock of their economy.

Sincerely,

Richard D. Copaken.

Harvard University Law School,
Cambridge, MA, July 19, 1989.

Hon. Bennett Johnston,
Hon. James McClure,
U.S. Senate

Dear Senators Johnston and McClure: For several months I have been retained by the Commonwealth of Puerto Rico through its lead counsel in Washington, Richard Copaken, a partner in the law firm of Covington & Burling, to consult and provide objective expert advice on a number of constitutional questions that have arisen in the context of the political status referendum contemplated in S. 712. At the outset of this work I made it clear that I would not undertake such an assignment as an advocate and would have to retain the freedom to express my personal views, whether or not those views coincided with the judgment or wishes of the Governor and the political party he leads. And in fact, the Governor has structured the Commonwealth proposals that have been finally presented to you to comply fully with all of the constitutional considerations I have raised.

Accordingly, you may rely on the accompanying memorandum of law analyzing the Tax Uniformity Clause as it applies to the debate on S. 712 (jointly prepared by me and Covington & Burling) as reflecting my own opinion and best judgment. The very same assurance applies to my letter to you of June 13, 1989, on the issue of citizenship and to the letter and accompanying memorandum of June 14, 1989, on the constitutionality of Section 4(c) of S. 712. The same will be true of subsequent memoranda I may be forwarding to you, as time permits, regarding other constitutional issues that arise under S. 712. Although it would appear that the academic consultant retained by the Statehood party views his role differently, I write as a professor of constitutional law and not as an advocate of any of the political status choices being offered to the people of Puerto Rico.

Professor Gewirtz's testimony before your committee is wrong in asserting that sections 933 and 936 of the Internal Revenue Code as presently structured can be made to survive statehood. The Tax Uniformity Clause of the United States Constitution prohibits Congress from providing the same targeted tax benefits to a State of Puerto Rico as it now constitutionally provides to the Commonwealth of Puerto Rico. The Uniformity Clause bars special tax treatment for a State of Puerto Rico as a naked preference for that state *as* a state. And clothing that preference with artful draftmanship, as Professor Gerwitz suggests, would not help.

The Supreme Court's decision in *United States* v. *Ptasynski*, 462 U.S. 74 (1983), on which Professor Gewirtz places so much reliance, does not stand for the proposition for which he seeks to make it stand: that Congress can favor a state of Puerto Rico if only it can find some seemingly neutral geographical description that encompasses all of Puerto Rico and only Puerto Rico or some subject of tax exemption that is found only in Puerto Rico. What *Ptasynski* teaches is in fact the opposite: that if there were some neutral justification for the favoritism shown to Puerto Rico by sections 933 and 936 of the Internal Revenue Code, Congress would not have to try to hide what it was doing, and that "where Congress does choose to frame a tax in geographic terms," the Court "will examine the classification *closely* to see if there is actual geographic *discrimination.*" Id. at 85 (emphasis added). To maintain sections 933 and 936 after statehood in anything like their current form would be to afford Puerto Rico exactly the undue preference and actual geographic discrimination that the Court determined Congress was not giving to Alaska by exempting a small fraction of its oil from the Windfall Profits Tax.

The enclosed memorandum also demonstrates why Professor Gewirtz's other claimed precedent involving the exemption of some air transportation between the rest of the United States and Hawaii and Alaska from the air transportation excise tax—the constitutionality of which has never been adjudicated by a court—also is no precedent for the continuation of sections 933 and 936 after statehood. The legislative history of section 936 leaves no doubt that this provision is avowedly discriminatory and designed to confer economic advantages on the Commonwealth. While such economic favoritism is permitted with respect to entities that are not states of the Union, it would collide with the Uniformity Clause the moment Puerto Rico became a state.

Although there can be no doubt about Congress's power to cushion the effect of Puerto Rico's entering the Union with direct economic assistance to the newly formed state, if it so chose, the Constitution forbids "phasing out" tax legislation that on its face contains the kind of discrimination along state lines the Uniformity Clause forbids. The Supreme Court's well-known "equal footing" decision, *Coyle* v. *Smith*, 221 U.S. 559 (1911)—on which Professor Gewirtz purports to rely elsewhere—conclusively demonstrates the vulnerability to judicial attack of transitional provisions in enabling acts that seek to continue, even for only a few years, conditions barred by the Constitution. In its enabling act admitting Oklahoma as a state into the Union, Congress provided that the state capital would have to remain "temporarily" in Guthrie, the territorial capital, and phased out its requirement six and one-half years later, i.e., provided that the capital could be moved no earlier than 1913. The Supreme Court struck down the requirement as an unconstitutional infringement of state sovereignty that was repugnant to the equal footing doctrine—in spite of the avowedly *temporary* nature of the requirement. A state of affairs either offends the Constitution or it does not. The contrary position is the constitutional equivalent of arguing that a woman is not really pregnant since her condition will be "phased out" in nine months.

I commend your dedicated determination to place before the people of Puerto Rico three genuine and fully articulated choices. With all the best intentions in the world Congress cannot assure the people of Puerto Rico that section 936 of the Internal Revenue Code can continue for one moment after statehood any more than Congress could assure the landowners in Guthrie that the capital would remain there for at least a six and one-half year temporary transition period.

Sincerely yours,

LAURENCE H. TRIBE.

July 18, 1989.

MEMORANDUM OF LAW

RE: ANALYSIS OF THE UNIFORMITY CLAUSE AS IT APPLIES TO THE DEBATE ON S. 712

The Committee recently heard the testimony of Professor Gewirtz on behalf of the Pro-Statehood New Progressive Party of Puerto Rico. In his testimony, Professor Gewirtz stated, inter alia, that Congress has the power to vary the otherwise geographically-uniform (in the 50 states) provisions of the Internal Revenue Code in their application to a newly-formed State of Puerto Rico. He asserts that Congress clearly has the power to frame special tax treatment for Puerto Rico in "geographic" or "subject" terms and to phase out the preferential treatment for a State of Puerto Rico under the tax code, without significant constitutional objection. Professor Gewirtz is mistaken.

Under Commonwealth, Section 933 of the Internal Revenue Code exempts from Federal income taxation individual income earned from Puerto Rican sources, thus freeing most Puerto Rican residents from paying any Federal income taxes. Moreover, Section 936 of the Code exempts from Federal income taxation income earned in Puerto Rico by United States corporations. Puerto Rico thereby enjoys favorable tax treatment as a Commonwealth that none of the 50 states enjoys. Section 936, in particular, is a foundation of the Puerto Rican economy; without it, much of that economy's growth in recent years would not have occurred. Were it to be eliminated, the growth would end and Puerto Rico would fall into direr poverty. The constitutional constraints on the federal tax status of Puerto Rico, if it were to become a state, are thus a matter of vital importance.

Professor Gewirtz is wrong in asserting that Sections 933 and 936 can be made to survive statehood, because the Constitution of the United States would limit Congress's ability to perpetuate the present favorable tax status for Puerto Rico if it became a state. The Tax Uniformity Clause of the Constitution (Article I, Section 8, clause 1) requires that Congress levy income taxes and certain other taxes in a geographically uniform, non-discriminatory manner. Thus, Congress may not constitutionally provide the same targeted tax benefits to a State of Puerto Rico as it now constitutionally provides to the Commonwealth of Puerto Rico.

The Tax Uniformity Clause is not the almost meaningless invitation to artful legislative drafting that Professor Gewirtz depicts. It is true that relatively few cases have been decided under it, and, as Professor Gewirtz says, the Supreme Court has never relied on it to invalidate a congressional tax provision (Gewirtz Testimony 17). But he draws an entirely false lesson from the latter fact. The Uniformity Clause has been a constitutional success story precisely because it is a readily understood limitation on congressional power and, thus, has discouraged Congress from attempting disparate tax treatment of states. What the clause means is that, because of the uniquely destructive capacity of the power to tax, Congress may not favor one state or region over another in tax legislation.

Nor is the power to spend constitutionally equivalent to the power not to tax, as Professor Gewirtz wrongly suggests. Thus, Congress's authority to single out a State of Puerto Rico for special *expenditures* to "cushion" the effects of the loss of Section 936 does not give it authority to "phase out" Section 936 *tax* benefits over an undisclosed period, as suggested by Professor Gewirtz.

Under the Uniformity Clause, special tax treatment for a State of Puerto Rico as a naked preference for that state could not continue in anything like its present form. And clothing that preference with artful draftsmanship, as Professor Gewirtz suggests, would not help.

Discussion

I. TEXT, PURPOSE, SCOPE AND INTERPRETATION OF THE UNIFORMITY CLAUSE

The Constitution provides:

> "The Congress shall have Power To lay and Collect Taxes, Duties, Imports and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imports and Excises shall be uniform throughout the United States . . ." United States Constitution, Art. I, § 8, cl. 1.

Congress's taxing power is limited by the second part of the quoted sentence, which we know as the "Tax Uniformity Clause." The clause requires that all duties, imports, and excises—which have come to be characterized as "indirect" taxes—be "uniform," in contrast to "direct" taxes, which must be apportioned by population among the states, Art. I, § 2, cl. 3, as measured by the census, Art. I, § 9, cl. 4. Apportionment has proved so formidable an obstacle that Congress does not enact "direct" taxes.

A. The Purpose of the Uniformity Clause

The purpose of the Uniformity Clause is clear. In the general debate over the power of the Federal Government to regulate commerce between the states, some states "remained apprehensive that the regionalism that had marked the Confederation would persist. . . . There was concern that the National Government would use its power over commerce to the disadvantage of particular States. The Uniformity Clause was proposed as one of several measures designed to limit the exercise of that power." *United States* v. *Ptasynski*, 462 U.S. 74, 81 (1983) (citations omitted).

As one distinguished commentator explained:

> [The purpose of the Clause] was to cut off all undue preferences of one State over another in the regulation of subjects affecting their common interests. Unless duties, imports, and excises were uniform, the grossest and most oppressive inequalities, vitally affecting the pursuits and employments of the people of different States, might exist. The agriculture, commerce, or manufactures of one State might be built up on the ruins of another; and a combination of a few States in Congress might secure a monopoly of certain branches of trade and business to themselves, to the injury, if not to the destruction, of their less favored neighbors." 1 Story, *Commentaries on the Constitution of the United States* § 957 (T. Cooley ed. 1873), *quoted in Ptasynski*, 462 U.S. at 81.

Thus, the Uniformity Clause limits Congress's power to create special tax treatment—favorable or unfavorable for an individual state as defined by its political boundaries. Because the power to tax is "essentially a power to destroy," *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316, 391 (1819), the constitutional convention expressly limited Congress's ability to single out particular states or groups of states for disparate treatment.

B. Applicability of the Uniformity Clause to the Federal Income Tax

The Uniformity Clause governs duties, imports and excises—indirect taxes. *United States* v. *Ptasynski*, 462 U.S. 74, 80 (1983). We deal here with the Federal income tax. Professor Gewirtz says that it is still a debated proposition whether the income tax is an indirect tax subject to the Uniformity Clause. (Gewirtz Testimony 16-17.) The debate is not a very serious one. True enough, the Sixteenth Amendment had to be adopted in response to the decision in *Pollock* v. *Farmers' Trust and Loan Co.*, 157 U.S. 429 (1895), holding that a tax on the rents or income of real estate was a direct tax subject to the impossibly demanding apportionment clauses of Article I, § 2, cl. 3, and § 9, cl. 4. The Sixteenth Amendment empowers Congress to "lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States and without regard to any census or enumeration." But the Sixteenth Amendment, by the quoted reference to the freedom of the income tax from the apportionment requirement, was not meant to classify a tax on every source of income as direct. *Brushaber* v. *Union Pacific Railroad Co.*, 240 U.S. 1, 18-19 (1916). The Court in *Brushaber* remarked that, if the income tax in all its aspects were a direct tax, the Sixteenth Amendment would have the effect of authorizing Congress "to impose a different tax in one State or States than was levied in another State or States," id. at 12, because the income tax is free of the apportionment requirement by the terms of the Amendment and, as a direct tax, would not be subject to the Uniformity Clause. The Court declared: "This result, instead of simplifying the situation and making clear the limitations on the taxing power, which obviously the Amendment must have been intended to accomplish, would create radical and destructive changes in our constitutional system and multiply confusion." Id. There is no real debate after *Brushaber* that the Federal tax on income is indeed subject to the Uniformity Clause.

C. The Supreme Court's Interpretation of the Clause

The jurisprudence of the Uniformity Clause as it stood before *United States* v. *Ptasynski* was ably summed up by Chief Justice Stone in *Fernandez* v. *Wiener*, 326 U.S. 340, 359 (1945). He said, citing *Knowlton* v. *Moore*, 178 U.S. 41, 83-109 (1900), that "the uniformity in excise taxes demanded by the Constitution is geographical uniformity, not uniformity of intrinsic equality and operation." In other words, there cannot be one tax in Kentucky and another in Colorado, but a tax on bourbon whiskey or thoroughbreds, on the one hand, or on the sale of skis on the other is not condemned by the Uniformity Clause for its unequal effect in the two states because the "Constitution does not command that a tax 'have an equal effect in each state,' " the last phrase again quoted from *Knowlton* v. *Moore*, 178 U.S. at 104. Finally, "within the meaning of the uniformity requirement a 'tax is uniform when it operates with the same force and effect in every place where the subject of it is found,' " quoting *Head Money Cases*, 112 U.S. 580, 594 (1884). The opinion in *Fernandez* v. *Wiener* added to the accumulated doctrine the obvious point that the Uniformity Clause is not a super-demanding equal protection clause. Congress, the Court held, could rationally distinguish as the subject of an estate tax the passage of community property at death from the passage of property interests resembling community property that were privately created in common-law jurisdictions. That being so, a Louisiana estate had no complaint under the Tax Uniformity Clause against the Federal estate tax levied on it. 326 U.. at 361-63.

That brings us to *United States* v. *Ptasynski*, which along with the untested exemption of flights to and from Alaska and Hawaii from an air travel excise tax is almost the entire basis of Professor Gewirtz's argument. Contrary to that argument, however, *Ptasynski* does not mean that any jerry-built tax exemption designed to benefit Puerto Rico and Puerto Rico only will satisfy the Uniformity Clause. It says that a tax may be phrased in geographic terms insofar as these constitute a proxy for—in that case—higher costs that called for 'exemption from a gross receipts tax. It expressly does not mean that every tax phrased in geographic terms satisfies the Uniformity Clause.

II. THE UNIFORMITY CLAUSE PERMITS TAXES THAT MAKE DISTINCTIONS ON THE BASIS OF GEOGRAPHICAL FEATURES, BUT WOULD BAR THE TAX ADVANTAGES NOW ENJOYED BY THE COMMONWEALTH

A. The Test in Ptasynski

United States v. *Ptasynski*, 462 U.S. 74 (1983), demonstrates that, while the Uniformity Clause is simple and straightforward, it is not wooden. It does not force us into a constitutional jurisprudence of labels. Congress could not constitutionally lay a tax on "Virginia tobacco"—if by that phrase Congress meant tobacco indistinguishable from other tobacco except for being grown in Virginia. But it could tax (by that name if it chose) what the trade knew as "Virginia tobacco," if that were indeed a product different from other tobacco and if it were taxed without regard to where it was in fact grown.

So in *Ptasynski*. Congress freed from the Crude Oil Windfall Profits Tax something it called "exempt Alaskan oil defined as "crude oil produced through a well located north of the Arctic Circle, or . . . on the northerly side of the divide of the Alaska-Aleutian Range and at least 75 miles from the nearest point on the Trans-Alaska Pipeline System." 462 U.S. at 77. The Supreme Court noted that, "[a]lthough the Act refers to this class of oil as 'exempt Alaskan oil,' the reference is not entirely accurate," id., because the exemption covered only a small part of the oil produced in Alaska, id. at 77, and because "exempt Alaskan oil" included oil produced outside of Alaska—"[o]il produced in certain offshore territorial waters—beyond the limits of any State," as the Court stated id. at 78-79. Indeed, the Court noted that only 5.1 percent of the oil currently produced in Alaska was "exempt Alaskan oil." Id. at 77 and n.5.

The Court held in *Ptasynski* that the treatment of "exempt Alaskan oil" in the Windfall Profits Tax did not offend the Uniformity Clause. That Congress had used the convenient shorthand "exempt Alaskan oil" to describe the subject of the exemption did not mean that it had stepped over the line drawn in the *Head Money Cases*—that a "tax apply, at the same rate, in all portions of the United States where the subject of the tax is found." 462 U.S. at 84. The Court said that a tax defined in geographic terms may be valid because the Uniformity Clause "does not prohibit [Congress] from considering geographically isolated problems," id., but it emphasized that, "where Congress does choose to frame a tax in geographic terms, we will examine the classification *closely* to see if there is actual geographic *discrimination*." Id. at 85 (emphasis added).

The Court looked closely and found "[n]othing in the Act's legislative history [that] suggests that Congress intended to grant Alaska an undue preference at the expense of other oil-producing States." 462 U.S. at 86. There was no "indication that Congress sought to benefit Alaska for reasons that would offend the purpose of the Clause." Id. at 85. Indeed, that was "especially clear because the windfall profit tax itself falls heavily on the State of Alaska." Id. at 86. Of all the oil produced in Alaska, 82.6 percent was subject to the windfall profit tax. Id. at 77 n.5.

It was not undue preference for Alaska but recognition of the special nature of the small proportion of Alaska oil that qualified as "exempt Alaskan oil" that gave rise to the exemption. The Court emphasized the "ample evidence" before the Congress "of the disproportionate costs and difficulties—the fragile ecology, the harsh environment, and the remote location—associated with extracting oil from this region." Id. at 85. These geophysical factors were described by the Court as "neutral factors;" the Court specifically found that "[t]he exemption . . . is not drawn on state political lines." Id. at 78. The Court acquiesced in Congress's finding of a relationship between the difficulty of extracting oil under such conditions, the price incentive for exploration for oil in such areas, and the national interest in encouraging such exploration at a time when the country was trying to reduce its dependence on foreign oil. Id. at 85-86. While some producers of oil in Alaska profited by the exemption, any advantage to Alaska as a state was purely incidental to the purposes of the tax.

Thus, *Ptasynski* does not stand for the proposition for which Professor Gewirtz seeks to make it stand: that Congress can favor Puerto Rico if only it can find some seemingly neutral geographical description that encompasses all of Puerto Rico and only Puerto Rico or some subject of tax (really some subject of tax exemption) that is found only in Puerto Rico. What *Ptasynski* teaches us is in fact the opposite: that, if there were some neutral justification for the favoritism shown to Puerto Rico by Section 933 and 936 of the Internal Revenue Code, Congress would not have to try to hide what it was doing. But there is no possible justification—comparable to the justification found in the rigors of the north for exempting from what amounted to a gross receipts tax on oil production the most northerly, difficult and costly oil—for the exemption of *all* Puerto Rican-source income from the net income tax paid by corporations and from the income tax paid by individuals. The corporation income tax, as a net tax, already takes account of any special expense burden associated with doing business in an insular tropical setting, and the tax on individual income is designed to relieve poor people, who disproportionately inhabit Puerto Rico, of a tax burden borne by those who are better off. To maintain Sections 933 and 936 after statehood would be to accord Puerto Rico exactly the undue preference that Congress was not giving to Alaska by exempting that fraction of its oil that was "exempt Alaskan oil" from the Windfall Profits Tax.

B. The Hawaii/Alaska Transportation Tax

No justification for that preference is suggested by Professor Gewirtz's other claimed precedent, the exemption of some air transportation between the rest of the United States and Hawaii and Alaska from the air transportation excise tax, 26 U.S.C. §§ 4261, 4262. (Gewirtz Testimony 19-20.) This Alaska/Hawaii exemption has not been subjected to a court challenge under the Uniformity Clause in any reported case. The exemption in any event is based on geographic and geophysical factors—distance from the mainland, the necessity of flying over foreign lands or international waters to reach either of the exempted states, and the difficulty of travel—consistent with *Ptasynski*.

The original transportation excise tax was passed as a wartime measure. Beginning in 1946, specific exemptions lifted the tax for specified areas. At first these included only Europe, Asia, and South America, but in 1956 a bill to amend the tax was reported that would have eliminated the tax for travel to our "best friends and customers," Canada and Mexico, or any of the Caribbean countries, but would have retained the tax on travel to the territories of Hawaii and Alaska. 102 Cong. Rec. 5831 (1956) (Sen. Smathers).[1] This was regarded as "unwarranted inequity," and "discrimination" against Alaska and especially Hawaii, which competed for many of the same tourist dollars as the Commonwealth of Puerto Rico and the Virgin Islands. 102 Cong. Rec. 5831 (1956) (Sen. Morse). The bill to enlarge the 1946 exemption was itself broadened to include Alaska and Hawaii within the exemption and, as so broadened, was enacted. 70 Stat. 644. Thus the original intent of the Hawaii/Alaska exemption, far from seeking to discriminate in favor of Alaska or Hawaii, was to *eliminate* discrimination *against* these two territories.

The transportation tax exemption for Alaska and Hawaii was simply allowed to remain in effect when they were admitted as states a few years later.[2] The reason for this, as explained by Senator Morse in the 1956 debate when statehood for the two territories was already seen as a possibility, was that "[t]heir becoming states will not change their geographical location, and the transportation tax handicap resulting therefrom." 102 Cong. Rec. 5831. Accordingly, the isolation of Hawaii and Alaska is a neutral factor permitting a geographically-based departure from strict uniformity in the application of the tax laws.

Sections 933 and 936 are quite otherwise. The special tax treatment of Puerto Rico embodied in those sections is not a neutral function of its geography. The provisions are openly and avowedly discriminatory. The legislative history of Section 936 demonstrates that Congress enacted it largely in hopes of stimulating economic growth in Puerto Rico and other United States possessions. *See* S. Rep. No. 94-938, 94th Cong., 2d Sess. 277-79 (1976). Section 936 focuses straightforwardly on economic advantages and disadvantages for the Commonwealth and for United States possessions and freely associated states. While such economic favoritism is permitted with respect to entities that are not states of the Union, it would collide with the Uniformity Clause the moment Puerto Rico became a state. Section 936 extended to a state would constitute precisely the economic regionalism and favoritism the founders intended to avoid.

III. CONGRESS MAY NOT PHASE IN FEDERAL INCOME TAXES AND PHASE OUT SECTIONS 933 AND 936 FOR A NEWLY-ADMITTED STATE OF PUERTO RICO

There is one final point. Professor Gewirtz asserts in his testimony that Congress could phase out the benefits, of Sections 933 and 936 for a newly admitted State of Puerto Rico. Apparently he means to say that, accepting them as the preferential provisions they are, Congress could nevertheless keep them in effect for five, ten, fifteen, twenty—Professor Gewirtz does not say—years to cushion the effect of statehood on Puerto Rico and its residents and the corporations doing business there. The Uniformity Clause permits no such thing. There can be no phasing in or phasing out of tax legislation that on its face contains the kind of discrimination along state lines the Uniformity Clause forbids.

The well-known "equal footing" case, *Coyle* v. *Smith*, 221 U.S. 559 (1911), demonstrates the emptiness of phasing in or phasing out as a constitutional concept. In its enabling act admitting Oklahoma as a state into the Union, Congress provided that the state capital would "temporarily" be in Guthrie, the territorial capital, and phased out this requirement six and one-half years later, i.e., provided that the capital could be moved no earlier than 1913. Act of June 16, 1906, 34 Stat. 267, c. 3335 (*quoted in Coyle*, 221 U.S. at 554). The Supreme Court held that Congress could not impose conditions in admitting a new state "which would not be valid and effectual if the subject of congressional legislation after admission." Id. at 573. Thus, the Court found the state capital requirement an unconstitutional infringement of state sovereignty repugnant to the equal footing doctrine—in spite of the avowedly *temporary* nature of that requirement.

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[1] A secondary consideration of the bill was to correct a tax evasion practice encouraged by the old law, which had the effect of diverting traffic away from American-flag carriers to foreign-flag carriers covering the same routes. The diversion occurred because it was cheaper in some instances for United States citizens to fly first to certain airports in Mexico and Canada when their real destination was one of the border states or Alaska or Hawaii, and was therefore subject to tax. 102 Cong. Rec. 5831-32 (1956) (Sen. Morse).

[2] This required no acknowledgement in the enabling acts for Alaska and Hawaii, since the relevant provision of the tax code, as amended in 1956, defined the term "continental United States" to mean "the existing 48 States and the District of Columbia." § 4262(c)(1), 70 Stat. 644, 645. The definition of "continental United States" in the tax code was amended after Alaska became a state to read "the District of Columbia and the States other than Alaska," 73 Stat. 146, and after Hawaii also became a state to read "the District of Columbia and the States other than Alaska and Hawaii," 74 Stat. 416.

Coyle is the case that Professor Gewirtz speaks of in a slightly different context as a "bedrock." (Gewirtz Testimony 27). It teaches that, contrary to Professor Gewirtz's contention, an unconstitutional condition in an enabling act is not saved by being "phased out," even if phased out quite soon after statehood. The Supreme Court's decision in *Coyle* came less than two years before Oklahomans would have been free to move their capital, but the Court did not stay its hand on that account. A state of affairs either offends the Constitution or it does not. The opposing position is the constitutional equivalent of arguing that a woman is not really pregnant since her condition will be "phased out" in nine months.

Professor Gewirtz cites a 1980 report of the Comptroller General, *Experiences of Past Territories Can Assist Puerto Rico Status Deliberations*, in support of his claim that Congress may "temporarily adjust the tax laws and grant temporary special tax treatment" to Puerto Rico during the initial years of its statehood. (Gewirtz Testimony 21.) He mischaracterizes the substance of the report, which merely described the nature of Federal *non*-tax legislation designed to facilitate Alaska's entry into the United States. The only tax provision mentioned in the report is the Alaska/Hawaii transportation tax exemption. That was not something phased in or to be phased out but appears to be as permanent as any provision of the tax code, and, as explained above, the exemption is fundamentally different from the type of politically-defined legislation at issue here. There is nothing in the Comptroller General's report to support the novel proposition that Congress may "temporarily adjust" the tax laws in favor of Puerto Rico without running afoul of toe Uniformity Clause.

Similarly unsupported is Professor Gewirtz's claim that "regardless of what the Uniformity Clause might restrict," it is somehow "intersected by" Congress's authority to admit new states into the Union under Article IV of the Constitution in a way that would allow Congress to ignore the Uniformity Clause. (Gewirtz Testimony 20.) This extraordinary claim stands without any citation of legal support—and we have been able to discover none that could support it. Legislation that violates a constitutional proscription is not rescued by being enacted under the guise of another affirmative source of congressional authority that might be constitutionally legitimate in a different context.

Of course Congress could, if it chose, elect to "cushion the effect" of Puerto Rico's entry into the Union with direct economic assistance to the newly formed state. That is not to say, however, that Congress could accomplish the same end by continuing for Puerto Rican residents and corporations doing business there advantages under the tax code not available in the other states. While the economic effect of these actions might be similar—though it is one thing to tax the average Puerto Rican resident less and quite another to grant his government more—their constitutional underpinnings are wholly different. There is no constitutional impediment to Congress's spending money in a way that differs from state to state. But the Uniformity Clause forbids effecting discriminatory treatment of states states through the taxing power. It is incorrect to suggest that, since Congress could give money away to benefit a particular state, it could a fortiori take less money away from the residents or corporations of the same state by selective application of the tax laws. The Constitution does not permit such sleight of hand. And surely Congress has not accepted the proposition that all property belongs to the government, and that there is thus no difference between the government giving some back (via the spending power) and not taking some in the first place (via tax exemptions).[3]

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[3] For a discussion of this proposition—acceptance of which would effectively mean the end of private property as we know it—see generally Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures With Direct Governmental Assistance*, 84 Harv. L. Rev. 352 (1970); Surrey, McDaniel & Ault, *Federal Income Taxation: Cases and Materials*, 239-76 (1972). The Supreme Court has rightly rejected this proposition. For example, in upholding against a challenge under the Establishment Clause New York's property tax exemption for places of worship, the Court declared: "The grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state." Walz v. *Tax Commission, 397 U.S. 664, 675 (1970).*

Finally, there is a glaring inconsistency between Professor Gewirtz's argument favoring preferential tax treatment for a State of Puerto Rico and the fundamental premise of his testimony—that Puerto Rico deserves statehood on grounds of equality, "an equal place in the American family and the American dream." (Gewirtz Testimony 5.) Professor Gewirtz laments what he calls Puerto Rico's present "separate but unequal" constitutional status, then argues moments later that a newly-formed State of Puerto Rico should be given tax treatment *more* than equal to that accorded the other states. This lack of consistency on so fundamental a matter is revealing, symptomatic, and deeply troubling. After hearing Professor Gewirtz's repeated calls for equality, his unembarrassed defense of more-than-equal tax treatment for a State of Puerto Rico is like the thirteenth chime of a clock: it makes one doubt all that has come before.

CONCLUSION

For the above reasons, the present sections 933 and 936 would offend the Constitution if extended—temporarily or permanently—to a State of Puerto Rico.

COVINGTON & BURLING,
Washington, DC, August 31, 1989.

Hon. J. BENNETT JOHNSTON,
Hon. JAMES MCCLURE,
U.S. Senate.

Dear Senators Johnston and McClure:

Enclosed is a most thoughtful letter from Professor Laurence Tribe of Harvard Law School updating his comments on the Tax Uniformity Clause issue to reflect his learned assessment of S. 712 as reported by the Energy and Natural Resources Committee on August 2, 1989. I understand that you disagree with Professor Tribe's view of the constitutional law issue. But I urge you to take a careful look at Professor Tribe's letter nonetheless because it not only describes the constitutional problem which S. 712 as reported clearly still raises, but also identifies on pages four and five two practical alternatives that are both unquestionably consistent with the Constitution.

Warmest personal regards.

Sincerely yours,

RICHARD D. COPAKEN.

HARVARD UNIVERSITY LAW SCHOOL,
Cambridge, MA, August 31, 1989.

Hon. BENNETT JOHNSTON,
Hon. JAMES MCCLURE,
U.S. Senate.

Dear Senators Johnston and McClure:

On July 19, 1989, I submitted to you a memorandum of law that I prepared jointly with the law firm of Covington & Burling concerning the constitutionality of special favorable treatment of a new State of Puerto Rico under the Federal tax laws. Our memorandum addressed assertions of Professor Gewirtz in his testimony on behalf of the Statehood Party that, despite the Tax Uniformity Clause of the United States Constitution, several forms of such favorable treatment would be constitutional. Our principal conclusion, summarized in my cover letter also dated July 19, was that if Puerto Rico were to become a state of the Union, the Constitution would forbid continuation, perpetually or for a limited "phasing out" period, of the present preferential treatment of Puerto Rico under the Federal income tax laws.

As I noted in the July 19 cover letter, these are my own best judgments as a professor of constitutional law, not those of an advocate for any particular Puerto Rican political party or position.

I write this further letter to address Section 213(d) of S. 712 as reported by the Energy and Natural Resources Committee on August 2. There one finds an embodiment of one of the things Professor Gewirtz said could constitutionally be done: a temporary continuation into statehood of both present aspects of preferential treatment of Puerto Rico under the Federal income tax laws and thereafter a termination of one, and a gradual phasing out of the other. Seeing the proposal in black and white does not change my opinion that such treatment is unconstitutional.

Section 213(d) of S. 712 as reported differs in some respects from the corresponding provision originally proposed by the Statehood Party. The Statehood Party would have continued Section 936 of the Internal Revenue Code—which exempts corporations from tax on income from Puerto Rican sources—in effect for 10 years after a proclamation of statehood and would have phased it out over the next 15 years. The current version of S. 712 would continue the Section 936 exemption until January 1, 1994, and would then reduce the amount of the exemption by 20 percentage points a year until it disappeared five years later. Given a referendum in 1991, that is a six-and-a-half year continuation during statehood of a provision that was enacted avowedly to discriminate in favor of the Commonwealth of Puerto Rico and intended explicitly to enable it to build a productive economy. I do not pretend to have an opinion on the wisdom of this change in the provision as reported. Both the original Statehood Party proposal and the provision as reported, however, are equally unconstitutional, condemned by the Tax Uniformity Clause as precisely the sort of outright preference of one state over others that the Clause was adopted to prevent.

Section 993 of the Internal Revenue Code is the other Puerto Rican tax preference provision of the present Code. It exempts from the personal income tax all income from Puerto Rican sources. Section 213(d) of the current S. 712 would continue that exemption until January 1, 1994, when it would end. That is a two-and-a-half year preference for Puerto Rico, but it is not saved from constitutional condemnation by its relative brevity. Under Section 213(d), a resident of a State of Puerto Rico would not pay the Federal income tax that residents of other states pay. I believe that the Uniformity Clause does not permit that kind of discrimination whether for two-and-a-half years, two-and-a-half decades, or forever.

It seems clear enough that Section 213(d) as reported is founded on the theory that the power to admit new states to the Union enables Congress to do things for fledgling states, by way of supposed transition, that it could not constitutionally do for more senior members of the Union. That this is the theory seems clear because there is no attempt to disguise the discrimination in favor of Puerto Rico, no effort to construct a tax exemption that would be justified by neutral, objective factors—as was the exemption of "exempt Alaskan oil" from the windfall profits tax in *United States* v. *Ptasynski*, 462 U.S. 74 (1983).

There is no substance to this theory. When the power to admit new states to the Union "intersects"—Professor Gewirtz's term—with a specific constitutional inhibition, the specific constitutional inhibition controls. The Uniformity Clause is a specific constitutional inhibition, and one of notable clarity. Congress is not able, in easing the way for a new state, to do things—even temporary things that can be characterized as phasing in or phasing out—that the Constitution would keep it from doing for an existing state.

We know that Congress cannot do something, even something temporary, *to* a new state that the Constitution does not empower it to do to states generally. That is the holding of *Coyle* v. *Smith*, 221 U.S. 559 (1911). Congress, in admitting Oklahoma to the Union, attempted to dictate where Oklahoma's state capital should be for just six-and-a-half years after statehood. The Supreme Court said no, holding that Oklahoma was entitled to be on an "equal footing" with the other states—as free to choose where its capital would be as the others surely were—from the date of statehood, not after some transition or phasing-in period.

There is no defensible argument for the view that the rule of *Coyle* does not cut both ways: just as Congress cannot do something to a new state that the Constitution forbids it to do to an existing state, so Congress cannot do something *for* a new state that the Constitution forbids it to do for an existing state. Any other rule would be unprincipled in theory and difficult if not impossible to administer in practice—especially since one can readily imagine cases in which it is exceedingly hard to tell which transition provisions amount to benefits for the new state, and which amount to burdens upon it.

The power to admit new states no more creates an exception to the Uniformity Clause than it provides an exception to any other limit on Congress' powers, notwithstanding the fact that such an exception might smooth the road of early statehood. The ability to handicap a new state temporarily could obviously facilitate acceptance of statehood by a majority in Congress, just as the ability to give a new state a temporary break could facilitate acceptance of statehood by the populace of the new state.

In admitting a new state with crowded courts, could Congress temporarily suspend the right to jury trial in criminal cases? Would such a suspension be something Congress had done *to* the new state's people or *for* them? In admitting a state that had formerly been a hereditary monarchy, could Congress overlook the guarantee of a republican form of government for the lifetime of the monarch then reigning? Would *that* be a benefit or a burden? In admitting a state where much-needed resources were in the hands of private owners, could Congress temporarily exempt the state from the requirement that just compensation be paid to citizens whose property is taken? Benefit or burden? These are not unfair analogies to what is being proposed to ease Puerto Rico's transition from the protective fostering policy of Commonwealth to the uncompromising and unprotected, single-market Union of States. From these analogies it can be seen that the Supreme Court's decision in *Coyle* v. *Smith* must stand for the proposition that Congress cannot condition admission of new states on standards that are different from those it may impose on states whether conceived as more beneficial or more burdensome. Indeed, the Court's decision in *Coyle* v. *Smith* would have to be overruled before one could follow Professor Gewirtz's erroneous advice.

Congress could not now exempt all citizens of Louisiana or Alaska from Federal income tax liability for more than two years, or grant Federal tax preferences for more than six years to corporations doing business in Idaho or Hawaii. No more can Congress free Puerto Rico of the Federal tax burden borne uniformly by all the other states.

I agree with Senator Johnston that Congress can and should do everything within its constitutional power to ensure the smooth entry of new states into the Union. One expedient way of accomplishing this would be to delay the commencement of statehood until after the phase-out of Sections 933 and 936 of the Internal Revenue Code was completed. Under such a plan, the selection of the statehood option by the voters of Puerto Rico would terminate Puerto Rican tax autonomy and begin a period of transition that would lead to statehood at a predetermined: future date. During this period a phase-out of tax benefits could operate similarly to that envisioned by Section 213(d) of S. 712 as reported. During this same period, maintaining Federal program benefits at current levels would not contravene the equal protection standard of the Due Process Clause of the Fifth Amendment. After all, the Supreme Court held in *Harris* v. *Rosario*, 446 U.S. 651, 652 (1980) (per curiam), that as long as Puerto Rico is not a state, Congress under its Territorial Clause power "may treat Puerto Rico differently from States so long as there is a rational basis for its actions"—a standard very easy to meet in practice.

As a non-state, the Commonwealth of Puerto Rico is not subject to the Tax Uniformity Clause today, and it is possible that the Supreme Court would hold the clause inapplicable to Puerto Rico during the transition period preceding statehood simply because Puerto Rico was still not a state. But even assuming that the applicability of the Tax Uniformity Clause hinges on the distinction between "incorporated" and "unincorporated" jurisdictions, it is clear that congressional intent controls what is "incorporated" and what is "unincorporated. *Downes* v. *Bidwell*, 182 U.S. 245 (1901). Indeed, in holding the Tax Uniformity Clause inapplicable to Puerto Rico in *Downes* v. *Bidwell*, the Court described approvingly Congress' "practical interpretation . . . that the Constitution is applicable to territories . . . only when and so far as Congress shall so direct." Id. at 279.

Thus, if Congress included in the referendum bill a provision expressly stating its intention that Puerto Rico not be considered "incorporated" as part of the United States during the pre-statehood transition period, the Tax Uniformity Clause surely would not bar unequal tax treatment for Puerto Rico, just as it does not bar such treatment now. Id.; see *Balzac* v. *Puerto Rico*, 258 U.S. 298, 305–06 (1922). In Balzac, the Court found in a unanimous opinion that the absence in the Foraker Act of an express congressional intention to incorporate Puerto Rico "strongly tends to show that Congress did not have such an intention;" especially after Congress has been alerted to incorporation as an issue, "incorporation is not to be assumed without express declaration." Id. at 306.

Thus, an express statement by Congress in the referendum act that the Tax Uniformity Clause was not to apply to Puerto Rico until statehood would be controlling—all the more so because the clause does not implicate fundamental individual rights. For while the concurring opinion in *Torres* v. *Puerto Rico*, 442 U.S. 465, 475–76 (1979), questioned the continuing relevance of *Balzac* to the issue before it—the applicability to Puerto Rico of the Fourth Amendment—its discussion revolved entirely around application of the Bill of Rights. Neither the concurring opinion in *Torres* nor any Supreme Court holding of which I am aware casts doubt on Congress' ability to declare whether an entity such as Puerto Rico is incorporated or unincorporated for purposes of the application of constitutional provisions outside the Bill of Rights. In short, the power of Congress to admit states combined with its residual plenary power under the Territorial Clause and its power under the Necessary and Proper Clause enable Congress to determine that an entity will not become a state until a predetermined future date, and that it not be considered "incorporated" as part of the United States until that date.

A second way to assist Puerto Rico in the transition to statehood is with direct economic assistance. It is clearly possible to assist a Puerto Rico in transition through the spending power—through Congress' ability to direct its appropriations to where they are needed—which power is not subject to any constitutional constraint like the Tax Uniformity Clause.

The fact that Section 213(d) of S. 712 as reported is unconstitutional thus does not mean that Congress is powerless to assist Puerto Rico in the transition to statehood from its status as a Commonwealth exempt from Federal taxes. I have identified for you two practical alternatives that are not mutually exclusive and that are fully consistent with the Constitution. What cannot be done is what Section 213(d) of S. 712 proposes to do.

Sincerely yours,

LAURENCE H. TRIBE.

COMMUNICATIONS

STATEMENT OF PUERTO RICANS IN CIVIL ACTION

STATEHOOD FOR PUERTO RICO & I.R.C. SEC. 936 [1]

To: The United States Senate Finance Committee
Re: Senate Bill 712

Honorable Senators: Thank ~~you for~~ the opportunity to express our views on Statehood for Puerto Rico and on Section 936 of the federal, Internal Revenue Code. Puerto Ricans in Civic Action is a grass roots movement that with the force of more than 350,000 individually signed petitions of individual United States citizens [2] living in Puerto Rico has essentially petitioned Congress for a redress of our grievances and requested Statehood for Puerto Rico, pursuant to Article IX of the Treaty of Paris of 1898, to end the present colonial status of Puerto Rico.

Because of the truncated time allowed me, I commence with the following highlights: (1) that federal, Internal Revenue Code sec. 936 is a scandalous waste of Federal funds,[3] which the United States can and should terminate soon, even now, under the present so-called Commonwealth status; (2) that any person concerned with revenue neutrality or equality among the political status formulas in the coming plebiscite must logically at least require the so-called Commonwealth to pay the $500 million every year which the so-called Commonwealth repeatedly promised to pay annually by 1985, to the Federal Treasury in lieu of Federal taxation upon Puerto Rico;[4] and (3) that Statehood is the only status formula that (a) categorically

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[1] Copyright 1988—Luis P. Costas Elena, (L.L.B., L.L.M., S.J.D.)

[2] Persons born in Puerto Rico are automatically United States citizens, since Article 5 of the Jones Act of 1917; Act of March 2, 1917, ch. 145, 39 Stat. 951, 953. See also Nationality Code of 1940; Act of Oct. 14, 1940, ch. 876, sec. 202, 54 Stat. 1139: "*All persons born in Puerto Rico on or after April 11, 1899,* subject to the jurisdiction of the United States, residing on the effective date of this act in Puerto Rico or other territory over which the United States exercises rights of sovereignty and not citizens of the United States under any other Act, *are hereby declared to be citizens of the United States.*" (emphasis added).

[3] See, e.g., U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report (March 1989) U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Fifth Report (July 1985); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Second Annual Report (June 1979); U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, First Annual Report (June 1978).

[4] See, e.g., Luis Munoz Marín, Governor of Puerto Rico, in Hearings On S. 2023 and Proposed Substitute S. 2708 before the Senate Comm. on Interior and Insular Affairs, 86th Cong., 1st Sess., Proposed Amendments to the Puerto Rican Federal Relations Act 37 44 (1959) : "The Commonwealth proposes—through this modification to begin sharing in the common burdens of the Union . . . This year the Legislature of Puerto Rico, feeling that our economic progress had made it feasible to begin acting on that principle, included a proposal to the effect . . . ;" "Are we proposing in this bill to share in the burdens of the Union? Yes; we are proposing to *begin sharing and sharing* increasingly as the economy of our government permits us to. This would also make Puerto Rico resemble a federated state more, not less." (emphasis added); Governor Luis Munoz Marín in 3 United States—Puerto Rico Commission on the Status of Puerto Rico, Hearings on the Status of Puerto Rico—Econonic Factors in Relation to the Status of Puerto Rico, S. Doc. No. 108, 89th Cong., 2d Sess. 25, 231 (1966) : "You recollect a resolution of the Puerto Rican Legislature, of December 1962 that a formula be worked out whereby *Puerto Rico will begin contributing* a part of its increased wealth, increased production from year to year, *to support the common burdens of the American union . . . ;* "*that return from Puerto Rico could be about as much as the Federal tax* at that time would be." (emphasis added) "Now, on the tax question, of course, you know that *we, upholders of the Commonwealth are proposing that Puerto*

Continued

accepts both the rights and responsibilities of United States citizenship, and (b) that can relieve the taxpayers and voters of each one of the States that you represent from the heavy and ever—increasing burden of the so-called Commonwealth of Puerto Rico. If you aid or tolerate that so-called Commonwealth in any way, you in effect crucify the taxpayers of your States, your constituents, on the cross of that Commonwealth and particularly with the nails of 936.

Statehood should not be an issue or in all honesty any problem. The costs, the immense, wasteful and ever increasing costs of "Commonwealth" are the issue and the problem.

Independence, no matter what Federal largesse is provided, means that Puerto Rico and the Puerto Ricans will have to fend for themselves. Statehood, no matter what the transition period, signifies that Puerto Rico and the Puerto Ricans will share the common burdens of the Union, such as Federal Taxes and other contributions to the United States. But, Commonwealth means now and in the future the continuation of current many billion dollar costs, the ever increasing multi-billion dollar waste of 936 and the continuous demands for more and more amendments to Federal laws (to food stamps, to Supplemental Social Security, etc.) to give Puerto Rico more and more Federal monies without any tax payments from Puerto Rico or the Puerto Ricans. From your point of view, Commonwealth is the supplicant of P.T. Barnum's adage, "There's a sucker born every minute."

The Director of the Harvard Law School International Tax Program, Mr. Glen Jenkins, and economist Mr. Tomas Hexner have kindly allowed me to present to you some of their findings concerning I.R.C. sec. 936 and regarding the 51st state—Puerto Rico:

"The US government could pay for the Commonwealth's transition to Statehood through its elimination of Section 936. Recently, the U.S. Department of the Treasury announced that revenue costs of the Section 936 tax program in 1989 are expected to be $1.9 billion. A tax reduction of 6 per cent, $0.9 billion would be necessary for citizens of Puerto Rico to pay Federal taxes without incurring higher tax burdens than the citizens of other low income states. Tax savings from 936 could cover this $0.9 billion with approximately $1.0 billion left over annually to finance development investments.

Who would pay the piper? The parent corporations of section 936 firms who have benefited from the tax credit (primarily through transfer pricing would now bear the costs.

Many have contended that the elimination of 936 would create havoc on the economy of the Commonwealth—decreased investment and increased unemployment. This contention is falacious because there are many more cost effective methods for promoting healthy economic growth.

Consider the following:

1. On average the tax revenues lost in 2.1 years would pay for the total investment these corporations have made in net fixed assets in Puerto Rico. (See Tables 1 and 3). For pharmaceuticals the revenue costs cover the costs of the assets in 1.5 years.

2. In terms of employment for pharmaceuticals the revenue cost of a dollar of wages is on the order of .250 per cent. (see Table 2).

These extremely high rates of tax loss are proof that the Section 936 provisions are primarily a tax shelter device for US parent corporations rather than an effective investment stimulus for Puerto Rico. Section 936 benefits neither the people of Puerto Rico nor the people on the mainland. The tax savings from 936 could be used in a development program for the Island, which would, for instance, pay for 50 per cent of fixed asset investment (after it is up and running) and save both the government of Puerto Rico and the Federal Government substantial sums.

The proposed plebiscite is also a time for self assessment. It is sad to note that the State tax burden (as a percentage of personal income) is 60 per cent higher for Puerto Rican residents than for residents of North Carolina, Indiana, and Mississippi, a good cross section of mainland America. If Puerto Rico chose statehood, an adjustment process will be necessary to bring its state taxes and expenditures in line with those of other states. This will take time. However, in subjective terms there appears to be a lot of fiscal fat which could be trimmed and used for development

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Rico begin to contribute, not in the form of taxes, *to the common burdens of all parts of the American Union*. It is our belief that we can make that contribution, and that if we can make it grow until it gets to whatever size it has to get according to a fair formula, it can be as much as taxes at a given time;" (emphasis added); Dr. Alvin Mayne, the economist for Commonwealth, in id. at 749: "I believe that *by 1985 the contribution of $500 million to the United States might be possible*—now, this is not an official statement, but it is a computation." (emphasis added) purposes. If section 936 savings could be applied to cover state expenditures, the transition could be accomplished by reducing Puerto Rican local taxes immediately. This tax room could then accommodate the introduction of the Federal taxes."

TABLE 1.—ASSET AMD PAYROLL INFORMATION FOR SELECTED SECTION 936 INDUSTRIES (1983)

	Net fixed assets (millions) [1] (1)	Number of employees [2] (2)	Average wage compensation per year [2] (3)	Revenue cost to U.S. Treasury (millions) [3] (4)
Pharmaceuticals	$1,160	$13,149	$21,823	$760
Electrical and electronic equip.	972	25,439	15,659	382
Apparel	100	15,628	10,408	51
Food	345	8,098	15,205	113
Other	908	26,265	N/A	335
Total	3,488	88,579	14,836	1,641

[1] Source: United States Department of the Treasury, "The Operation and Effect of Possessions Corporation System of Taxation, Sixth Report," March 1989, Table 4-1 (inventories included).

[2] Source: ibid., Table 4-6.

[3] Source: See note a, Table 4-5. Revenue cost to the U.S. Treasury is the dollar amount of the Section 936 tax credit that was claimed in 1983 by U.S. corporations operating in Puerto Rico.

TABLE 2.—REVENUE COST PER EMPLOYEE (1983)

[In thousands]

	Revenue cost per employee (1)	Average employee compensation (2)	Revenue cost per dollar of wages paid (3)
Pharmaceutical	$57,761	$21,823	$2.46
Electrical and Electronic equip.	15,005	15,659	0.96
Apparel	3,295	10,408	0.32
Food	14,003	15,205	0.92
All manufacturing industries	18,523	14,836	1.25

Source: U.S. Department of the Treasury.

Revenue cost is the dollar amount of tax credit claimed by corporations, minus income and tollgate taxes paid to Puerto Rico.

TABLE 3.—COST OF SECTION 936 PER DOLLAR OF CAPITAL, PER JOB AND PER JOB DOLLAR OF WAGE BENEFIT (1983)

	Cost per dollar of incremental wage benefit [1] (1)	Number of years for revenue cost to equal net assets (2)	Subsidy rate as a percentage of the annual cost of capital [2] (3)
Pharmaceuticals	$13	1.5	327%
Electrical and Electronic Equipment	5	2.5	196
Apparel	2	2.0	254
Food	5	3.1	163
Other	N/A	2.7	184
Total	6	2.1	235

[1] The dollar used is the incremental dollar. The Figures here represent the incremental wage benefit over the tax cost per job.

[2] This figure represents net assets multiplied by the cost of capital over total tax benefits.

I now point out some of my ideas to handle I.R.C. section 936 or make adjustments after Statehood, even for those who still have some desire to maintain that Federal tax expenditure:

(1) You can terminate I.R.C. sec. 936 now and substitute it with a direct Federal employment program for Puerto Rico, funded with amounts below what previously escaped the Federal treasury because of I.R.C. sec. 936.

(2) You can cap or segmentize I.R.C. sec. 936 and thereby stop or reduce its hemorrhage of Federal funds, for example, (a) by prohibiting the use of the tax sparing credit of I.R.C. sec. 936 after a certain cut-off date, (b) by phasing-out I.R.C. sec. 936 as you phased out Western Hemisphere Trade Corporations[5] and China Trade Act Corporations,[6] (c) excluding pharmaceutical mixing operations and electrical machinery assemblage from the definition of corporations that can use the tax sparing credit of I.R.C. sec. 936.

(3) You can eliminate 936 and substitute it with a national program of enterprise zones for all States whose statewide rate of unemployment is, for example, 14% or higher, which program would remain in place for the State until it lowered said unemployment to say 9% and maintained that lowered rate for a consecutive period of say 5 years.

(4) You can arguably prolong I.R.C. sec. 936 intact for a short period of time after Statehood for Puerto Rico.

The above segmentization or cap approach takes into account, for example, that although pharmaceutical section 936 operations obtain 46.3% of the total Federal cost of I.R.C. Sec. 936, such pharmaceuticals provide only 14.8% of the employment in Puerto Rico's manufacturing sector.[7] In 1987, according to the Puerto Rico Planning Board, the chemicals and related products sector, basically pharmaceuticals, had $3,757,600,000 of the $8,661,300,000 total net income of all the manufacturing sector in Puerto Rico,[8] but chemicals and related products only had 18,000 employees of the total 148,900 employed in manufacturing in Puerto Rico.[9] The shocking fact is that the "top sixteen possession corporations accounted for 24.2 percent of the tax benefits but provided only 3.6 percent of the employment of the 378" section 936 corporations in the Sixth Annual Report of the U.S. Treasury Department on I.R.C. sec. 936.[10] Sixteen section 936 corporations obtained $100,000 or more of the Federal tax expenditures of I.R.C. sec. 936 for each person they employed.[11]

The most effective choice for the Congress is the substitution of the present open-ended, unlimited, Federal tax expenditures of I.R.C. sec. 936 with a direct Federal unemployment program for Puerto Rico. Thereby you totally avoid the constitutional problems of geographic uniformity.[11] I recognize that the constitutional analysis of former Puerto Rico Secretary of the Treasury and of Justice Wallace Conzalez Oliver is ably presented [12] and is confirmed by Professor Arthur Sutherland of the Harvard Law School [13] and by Professor Alexander Bickel [14] of the Yale Law School, and more recently by Professor Cewirtz also of the Yale Law School. I recognize that even after Statehood, I.R.C. sec. 936 could perhaps persist for a short period of time, and accordingly that Professor Tribe's constitutional analysis [15] is too rigid and seemingly too politically partisan. However, there is no geographical uniformity condition on the Federal Constitution's expenditure clause; expenditures are expansively for the "general welfare." [16] And through the direct expenditure route, I emphasize, you achieve effectiveness and control for your present Federal tax expenditures. You and I should wholly agree with Professor Stanley Surrey of the Harvard Law School:

> "(A) tax incentive does involve the expenditure of government funds."

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[5] I.R.C. secs. 921, 922 (1987).

[6] I.R.C. sec. 941 (1987).

[7] U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation, Sixth Report, 51, 46 (Mar. 1989).

[8] Puerto Rico Planning Board, Informe Economico al Gobernador, 1987, at A-12, Table 12 (Feb. 12, 1988). See attached Exhibit A.

[9] Ibid. at IV-12. See attached Exhibit B.

[10] U.S. Department of the Treasury, Sixth Annual Report, supra. note 7, at 48.

[11] Idem. See attached Exhibits C and D.

[11] U.S. Constitution, Art. I, Sec. 8, cl. 1: "(A)ll Duties, Imposts and Excises shall be uniform throughout the United States."

[12] Wallace Conzalez Oliver, Power of Congress to Admit Puerto Rico as a State of the Union with Special Tax Treatment. (196-197O).

[13] Arthur E. Sutherland, Letter to Wallace Conzalez Oliver. (July 8, 1970).

[14] Alexander E. Bickel, memorandum for Wallace Conzalez Oliver. (July 22, 1970).

[15] Laurence H. Tribe & Covington & Durling, Niemorandum of Law Re: NPP Statehood Resolutions (Oct. 12, 1984).

[16] U.S. Constitution, Art I, Sec. 8, cl. 1: "The Congress shall have Power to . . . provide for the common Defense and general Welfare of the United States."

> "*A dollar is a dollar*—both for the person who receives it and the government that pays it, *whether the dollar comes with a tax credit label or a direct expenditure label.*"
>
> "(M)any incentives look, and are, highly irrational when phrased as direct expenditure programs structured the same way."
>
> "(A) resort to tax incentives greatly decreases the ability of the Government to maintain control over the management of its priorities."
>
> "*(T)ax incentives do involve — expeditures — 'back-door expenditures'* . . . and . . . *a legislator concerned with expenditure levels and expenditure control should not, while holding the front door shut, let hidden expenditures in through the back door.*" (emphasis added).[17]

We commence with the basic fact that Statehood for Puerto Rico is good both for Puerto Rico and for the United States. Among marry other benefits, Statehood would provide the United States citizens of Puerto Rico with the equality and dignity enjoyed by their fellow citizens in every State of the Union, provide Puerto Rico with the political stability necessary for economic progress, stimulate investment in Puerto Rico by eliminating the risk premium on such investments that the present foreignness of Commonwealth status causes,[18] and terminate the horribly wasteful Federal tax expenditures[19] now suffered by the United States because of I.R.C. sec. 936.[20] I.R.C. section 936 is a section of the Federal Internal Revenue Code that allows United States corporations, principally the "Fortune 500" to organize United States subsidiary corporations to do business basically in Puerto Rico. The "Fortune 500" parents then shift profits from their taxable operations in the United States or elsewhere to the Puerto Rican business (that receives Fomento Tax Exemption in Puerto Rico) and then retrieve those profits plus the tax free investment income generated by those profits almost completely free of both Federal and Puerto Rican income taxation either via the 100% intercorporate dividend deduction or a tax free liquidation. The parent companies then commence again this circle of avoidance of Federal income taxes by shifting other profit to the Puerto Rican operations. The I.R.C. section 936 subsidiaries do not pay Federal income taxes because they receive a Federal income tax credit for taxes that they have never paid. The credit device spares—excuses—the income covered by the credit from Federal taxation.

I.R.C. section 936 is one immense price that the United States continues to pay so as to prop up the so-called "Commonwealth" status of Puerto Rico. Not only has the "Commonwealth" of Puerto Rico never paid to the United States the annual contributions in lieu of Federal taxes that Governor Luis Munoz Marin promised in 1959 [21] and reiterated in 1965 [22] and that for 1985 should have been $500 million [23] but the United States via I.R.C. section 936 suffers tax expenditures that amounted to 1.167 billion in 1979; 1.326 billion in 1980: 1.711 billion in 1981; 1.678 billion in

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[17] Stanley S. Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harvard L. Rev. 705, 717, 721–722, 732 (1970).

[18] E.g., Office of Economic Research, Puerto Rico Development Administration, Analysis of the President's Tax Proposal to Repeal the Possession's Tax Credit in Section 936 of the U.S. Internal Revenue Code (J. Stewart & T. Lane) (Revised 1985) 7 n.1: "the risk premium demanded by firms on investments made outside the mainland;" R. Forbes, M. Hopewell, G. Kauffman & J. Petersen, The Outlook for Puerto Rico Municipal Bonds 73 (Preliminary Report for the Committee to Study Puerto Rico's Finances, July 30, 1975) 73: "All respondents generally agreed that Puerto Rico bonds—no matter what their particular quality or backing—suffered from the 'foreign country' syndrome."

[19] See generally supra notes 17 and 20.

[20] See my various articles in the Puerto Rican Bar Association Law Review: Costas Elena, I.R.C. Section 936 and Fomento Income Tax Exemptions in Puerto Rico, 40 Revista del Colegio de Abogados de P.R. 563–602 (Nov. 1979); Costas Elena, I.R.C. Section 936 and Fomento Income Tax Exemptions in Puerto Rico (Second Part), 41 Revista del Colegio de Abogados de P.R., 101–148 (Feb. 1980); Costas Elena, I.R.C. Section 936 and Fomento Income Tax Exemptions in Puerto Rico, 41 Revista del Colegio de Abogados de P.R. 225–277 (May 1980); Costas Elena, I.R.C. Section 936 and Fomento Income Tax Exemptions in Puerto Rico (Part IV), 42 Revista del Colegio de Abogados de P.R., 611–66P (Nov. 1981).

[21] E.g., Testimony of Governor Luis Munoz Marin, in Hearings On S. 2023 and Proposed Substitute of S. 2708 before the Senate Comm. on Interior and Insular Affairs, 86th Cong., 1st Sess., Proposed Amendments to the Puerto Rican Federal Relations Act 37 (1959).

[22] Statement of Luis Munoz Marin, in 3 United States—Puerto Rico Commission on the Status of Puerto Rico, Hearings on the Status of Puerto Rico -Economic Factors in Relation to the Status of Puerto Rico, S. Doc. No. 108, 89th Cong., 2d Sess. 233 (1966).

[23] Statement of the economist representing the position of Commonwealth in id. at 751: "We could probably make a contribution of $500 million by 1985."

1982;[24] and $1.641 billion in 1983.[25] Accordingly, in only these two Federal tax expenditure programs,[26] the cost to the United States of the present "Commonwealth" status exceeds $2 billion each year.

There is no need for further study or vacillation on I.R.C. section 936. Its utter failure to achieve its stated purpose of creating employment in Puerto Rico has been and is evident to all who wish to see. I.R.C. section 936 has not and cannot provide Puerto Rico with its desired opportunities for employment. In 1940 unemployment in Puerto Rico was 15%,[27] hovered around 20% from 1976 to 1986 and was 17.7% in 1987.[28] The sorry fact is that, as reported by the former Chief Justice of Puerto Rico's Supreme Court, in 1899 unemployment in Puerto Rico was 17%.[29]

About a decade ago I discovered that I.R.C. section 936 and its predecessor (I.R.C. section 931) were already among the ten highest corporate tax expenditures in the entire Internal Revenue Code;[30] and I wrote:

> "I.R.C. Section 936 is not working. I.R.C. section 936 will never work. What maintains I.R.C. Section 936 and Fomento tax exemptions are not benefits to Puerto Ricans since historically 'little of the profit earned by U.S. owners of Puerto Rican subsidiaries has been invested in the Puerto Rican economy' . . . but the vested interests . . . that benefit from those privileges."[31]

Since then the United States has shaved off some benefits of I.R.C. section 936, essentially to recoup some of the business deductions taken by the parent corporations while researching and developing the patents and other intangible property that the parent corporations subsequently transferred to the section 936 subsidiaries and that shifted the profit of such property to Puerto Rican exempt sources;[32] and Puerto Rico via partial exemptions and a toll-gate or withholding tax on dividends does receive a small cut or commission from the section 936 corporations in the aforesaid circle of avoidance;[33] but the basic failure to produce employment and the profit—shifting that lie at the center of I.R.C. section 936 have remained unchanged or grown worse.

In fiscal year 1986 the number of persons employed in the entire manufacturing sector of Puerto Rico was 148,000; and in fiscal year 1987 incremented by only 100 persons to 148,90O,[34] which is less than the 156,000 so employed in 1980.[35] However, net interest and profits in manufacturing rose from $5.331 *billion* in 1986 to $6.276 *billion* in 1987.[36]

Since 1970 the proportion of net income paid to Puerto Rican manufacturing employees has declined from 64% to 27.5 in 1987.[37] The reason is that more and more the greatest component of net income in the exempt manufacturing sector corresponds to the low employment—high profit pharmaceutical and electrical machinery operations. In 1987 the entire number of employees in basically pharmaceutical operations was 18,000 and in electrical machinery 20,000;[38] but their respective net incomes were $3.758 billion and $1.330 billion.[39]

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[24] Department of the Treasury, The Operation and Effect of the Possession Corporation System of Taxation, Fifth Report 53, Table 4-9 (July 1985).

[25] Department of the Treasury, Sixth Annual Report, supra note 7, at 44, 45.

[26] The nonpayment of the in lieu taxes, or I.R.C. section 933, and I.R.C. section 936.

[27] Junta de Planificacion de Puerto Rico, Informe Economico al Gobernador—1977, at A-26 (Jan. 25, 1978).

[28] Junta de Planificacion de Puerto Rico, Informe Economico al Gobernador—1987, at A-33, Table 29 (Feb. 12, 1988).

[29] Jose Trias Monge, 1 Nistoria Constitucional de Puerto Rico 7 (1st ed. 1980) (University of Puerto Rico Press).

[30] Compare U.S. Department of the Treasury, The Operation and Effect of the Possessions Corporation System of Taxation: First Annual Report 3 (June 1978) with Office of Management and Budget Special Analysis F: Tax Expenditures of the United States Government 108-109 (Feb. 1975).

[31] Luis P. Costas Elena, I.R.C. Section 936 and Fomento Income Tax Exemptions in Puerto Rico 403 (1979) (S.J D. Thesis for Harvard Law School).

[32] See generally, RNA Tax Management The Possessions Corporation Credit Under Section 936 (1987) Pursuant to I.R.C. sec. 56(f)(1) the dividend is subject to the corporate alternative minimum tax; but against it the domestic parent corporation can apply 50% of the Puerto Rican toll-gate tax and the payments to Puerto Rico on partially exempt operations as a foreign tax credit; see idem. 186-187.

[33] In fiscal year 1985, for example, out of 6.984 *billion* essentially exempt manufacturing net income, Puerto Rico obtained $44.7 *million* in corporate taxes on partially exempt income and $107.784 million in tollgate taxes on dividends; see Informe Economico al Gobernador—1987, at A-12, Table 12, A-26, Table 24; and Departamento de Hacienda, Informe Anual 1985, at 20, 50 (June 12, 1986).

[34] Informe Economico al Gobernador, 1987, at IV-4.

[35] Informe Economico al Gobernador, 1987, at A-35, Table 31.

[36] Ibid, at A-Il, Table 11.

[37] Ibid, at IV-10.

In 1988 Squibb reduced its Federal tax rate from 34.4% by 11.8 because of I.R.C. sec. 936.[40] In 1987 Eli Lilly and Company, because of its Puerto Rican operations, reduced its 40% Federal income tax rate by 10.7%.[41] In 1986 Westinghouse lowered its 1986 Federal statutory rate of 46% by 12.2% because of I.R.C. section 936.[42] And Baxter Travenol Laboratories Inc. obtained a 38.8% reduction in its federal tax rate of 46%, because of its tax exempt operations in 1985.[43]

Because of I.R.C. section 936, in 1982 the United States essentially paid the section 936 pharmaceutical subsidiaries $69,200 for each Puerto Rican employee to whom they paid $20,765 in compensation. The section 936 intermediary or middleman gained the other $48,435.[44]

To our mind we should eliminate the middleman. And Statehood now is the only logical solution. Any delay or postponement of Statehood for Puerto Rico means not only a denial of the aforesaid fact that Statehood is a good but also continues the immense, wasteful, costs of the present so-called Commonwealth.

We cannot any longer tolerate the illogic of Statehood in the future, for the future is never today and never comes.[45] Whatever adjustments are required or desired for the Union of Puerto Rico and the United States are precisely just adjustments, *after* Statehood.

Finally, some pointers on the drafting of the proposed Commonwealth formulation. Such a formulation should never imply or include words to the effect that "Commonwealth" means permanent union with the United States; for such words would communicate a falsehood and would make of the plebiscite a travesty.

Only Statehood signifies permanent union. Such is the basic fact of the United States, with effectiveness [46] decided in the Civil War and confirmed by the United States Supreme Court [47] in *Texas* v. *White*:[48]

> "When therefore, Texas became one of the United States, she entered into an indissoluble relation." "The Act which consummated her admission into the Union was something more than a compact; it was the incorporation of a new member into the political body. And it was final. The union between Texas and the other States was as complete, as perpetual, and as indissoluble as the union between the original States."
>
> "The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States."

The so-called "Commonwealth" is nothing more than a name, a label, attached to a category of indeterminate reference.[49] It has no content except in reference to history, the psychology and politics of the moment and the vagaries of interpersonal relations.[50]

But if you cannot define by inclusion; you can certainly define by exclusion. And excluded from the concept of "Commonwealth" is precisely the concept of permanent union. Indeed, nothing could be more alien or atavistic to the Union of the United States than the proposals of Governor Hernandez Colon before you which are tantamount to the doctrines of nullification and interposition of the Confederacy.[51]

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[38] Ibid, at IV-12.

[39] Ibid., at IV-7.

[40] Squibb Corporation Annual Report 1988, at 27. (Anniversary ed.).

[41] Eli Lilly and Company, 1987 Annual Report 35 (Feb. 8, 1988).

[42] Westinghouse, Annual Report 1986, at 37 (Jan. 31, 1987).

[43] Baxter Travenol Laboratories Inc., 1985 Annual Report (Feb. 28, 1986).

[44] Department of the Treasury, the Operation and Effect of the Possessions Corporation System of Taxation, Fifth Report 49, Table 4-6 (July 1985).

[45] In 1959 and again in 1965 for the Hearings on the Status of Puerto Rico, some argued that Statehood was 15 or 20 years in the future. In 1977 some again argued that Statehood was still 15 or 20 years in the future.

[46] Cf. Hans Kelsen, The Pure Theory of Law 208-214 (Max Knight trans.) (U. of California Press, 1967).

[47] Carl Brent Swisher, American Constitutional Development 327 (2d ed. 1978).

[48] 74 U.S. (7 Wall.) 700, 726, 725 (1868).

[49] Julius Stone, Legal System and Lacers' Reasonings 264 (1964).

[50] Luis Costas Elena, History of Federal Income Taxation in Puerto Rico; Analysis of the Possession Corporation in Comparison with Other Modes of Business Operation in Puerto Rico: An Insight into Tax Exemption in Puerto Rico, 36 Revista del Colegio de Abogados de Puerto Rico 477 527 (May 1975) (L.L.M. thesis for Harvard Law School).

[51] See John C. Calhoun, A Disquisition On Government and Selections from the Discourse xi-xv (Intro. by G. Post) (1853, reprinted 1953).

And Commonwealth assuredly repudiates the basic economic premise of permanent union, *Baldwin* v. *G.A.F. Seelig:*[52]

> "*The Constitution . . . was framed upon the theory that the peoples of the several states must sink or swim together, and that in the long run prosperity and salvation are in union* and not division."

States Saint Augustine, On Free Choice of The Will:[53]

> "Our freedom then consists in submission to the truth. It is our God Himself who frees us from death, that is, from the state of sin. Truth itself, when it speaks as a man, says to those who be, eve in Him, 'If you remain in My word you shall be My disciples indeed, and you shall know the truth and the truth will make you free'. The soul enjoys nothing with freedom, unless it enjoys it securely."

And such a truth is that such prosperity and security for Puerto Rico exists, and will exist, for Puerto Rico, only in the permanent union that is solely Statehood.

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[52] 294 U.S. 511, 523 (1934) (J. Cardozo) (emphasis added).

[53] Saint Augustine On Free Choice of The Will 69 (translated by A. Benjamin & L. Hackstaff) (published 1964).

TABLA 12 - INGRESO NETO DE LA MANUFACTURA: AÑOS FISCALES
TABLE 12 - NET MANUFACTURING INCOME: FISCAL YEARS

(En millones de dólares - In millions of dollars)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987p	
TOTAL	1,868.9	1,987.4	2,474.0	2,841.4	3,398.5	3,995.8	4,808.7	5,220.3	5,405.9	5,734.9	6,484.9	6,984.0	7,630.9	8,661.3	TOTAL
Alimentos y productos relacionados	245.3	285.1	326.0	381.6	442.8	496.6	548.5	644.8	681.6	564.8	753.8	833.8	896.0	981.3	Food and kindred products
Productos de tabaco	34.1	36.1	53.2	47.3	54.8	51.0	46.3	54.0	60.4	55.2	51.6	58.2	64.1	84.7	Tobacco products
Productos textiles	55.6	45.4	40.1	34.7	38.1	35.5	35.6	32.1	34.3	31.7	33.8	38.9	41.7	39.3	Textile mill products
Ropa y productos relacionados	215.8	205.5	261.6	268.2	302.4	329.3	360.7	373.7	375.1	408.2	451.3	406.4	410.1	422.2	Apparel and related products
Muebles y artículos de madera	28.5	30.1	29.8	28.5	24.3	28.7	29.6	30.0	27.2	27.3	29.1	31.1	32.4	35.5	Furniture and wood products
Impreso y publicaciones	35.6	42.6	41.2	39.9	47.3	53.1	58.8	62.5	65.7	69.5	77.1	79.9	91.8	107.7	Printing and publishing
Productos químicos y derivados	453.7	560.5	884.2	943.3	1,173.7	1,287.8	1,583.2	1,786.1	1,907.5	2,268.9	2,340.9	2,686.0	2,957.8	3,757.6	Chemical and allied products
Productos de piedra, arcilla y cristal	76.7	71.2	67.9	77.4	93.9	96.1	95.4	90.4	78.6	77.3	77.8	89.8	111.7	130.7	Stone, clay and glass products
Maquinaria y productos metálicos	445.5	484.0	607.9	778.7	922.0	1,197.8	1,453.7	1,721.4	1,828.3	1,752.5	2,164.3	2,293.9	2,543.8	2,607.3	Machinery and metal products
Productos de papel	15.6	19.4	18.5	19.3	21.9	24.3	26.5	28.1	31.0	32.7	38.1	49.2	48.0	46.9	Paper and allied products
Productos de cuero	34.8	33.9	32.5	34.3	42.5	51.2	64.9	73.8	68.5	82.2	89.1	85.9	95.5	92.0	Leather and leather products
Otra manufactura	227.7	173.6	111.1	188.2	234.8	344.3	505.6	323.3	247.7	364.5	378.0	331.0	338.0	356.1	Other manufacturing

p - Cifras preliminares.

Fuente: Junta de Planificación, Area de Planificación Económica y Social,
Negociado de Análisis Económico.

p - Preliminary figures.

Source: Puerto Rico Planning Board, Area of Economic and Social Planning,
Bureau of Economic Analysis.

-C-

TABLE 4-8

TAX BENEFITS, EMPLOYMENT, AND COMPENSATION OF EMPLOYEES BY SIZE OF TAX BENEFITS PER EMPLOYEE, 1983

	Number of returns	Qualified possession net income ($ thousand)•	Tax benefits		Employees	
			Amount ($ thousand)	Percent of total	Number	Percent of total
ALL FIRMS						
All manufacturing corporations	378	4,059,624	1,406,406	100.0	75,966	100.0
$100,000 or more	16	951,128	340,417	24.2	2,319	3.1
$ 50,000 under $100,000	23	967,573	343,204	24.4	5,018	6.6
$ 10,000 under $ 50,000	142	1,673,172	562,671	40.0	25,955	34.2
$ 5,000 under $ 10,000	57	283,731	103,338	4.3	15,511	20.4
$ 1,000 under $ 5,000	91	167,147	55,229	3.9	19,327	25.4
$ 500 under $ 1,000	11	2,983	1,126	*	1,599	2.1
$ 1 under $ 500	13	1,365	421	*	1,206	1.6
No tax benefits	25	12,525	0	0	5,031	6.6
FIRMS ELIGIBLE FOR TEFRA REQUIREMENTS						
All manufacturing corporations	292	2,959,327	1,010,705	100.0	58,877	100.0
$100,000 or more	10	550,004	198,553	19.6	1,354	2.3
$ 50,000 under $100,000	17	688,492	245,305	24.2	3,488	5.9
$ 10,000 under $ 50,000	115	1,364,772	449,380	44.5	21,638	36.8
$ 5,000 under $ 10,000	45	195,452	69,759	6.9	9,979	16.9
$ 1,000 under $ 5,000	71	144,819	46,578	4.6	15,902	27.0
$ 500 under $ 1,000	8	2,226	810	*	1,227	2.1
$ 1 under $ 500	9	1,037	320	*	923	1.6
No tax benefits	17	12,525	0	0	4,366	7.4

Department of the Treasury
Office of Tax Analysis

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* Less than 0.5 percent

• Equals net income from the active conduct of a trade or business in a possession plus net qualified possession source investment income.

-B-

NUMERO DE EMPLEOS EN LA MANUFACTURA POR GRUPO INDUSTRIAL
(En miles de personas-Años fiscales)

SIC	Grupo Industrial	1970	1980	1985	1986	1987	Cambio			
							Absoluto		Porcentual	
							1986/1985	1987/1986	1986/1985	1987/1986
	TOTAL	136.2	155.5	148.8	148.8	148.9	0.0	0.1	0.0	0.1
20	Alimentos y relacionados	21.7	23.3	22.3	22.3	22.6	0.0	0.3	0.0	1.3
21	Tabaco y productos de tabaco	6.1	2.1	0.8	0.8	1.3	0.0	0.5	0.0	62.5
22	Productos textiles	8.1	4.0	2.8	3.3	3.4	0.5	0.1	17.9	3.0
23	Ropa y productos análogos	38.1	34.3	30.9	31.1	30.5	0.2	-0.6	0.6	-1.9
24	Madera y productos de madera	0.7	1.1	0.8	0.9	1.1	0.1	0.2	12.5	22.2
25	Muebles	4.1	2.8	2.3	2.4	2.5	0.1	0.1	4.3	4.2
26	Papel y relacionados	1.4	1.6	1.7	1.7	1.7	0.0	0.0	0.0	0.0
27	Imprenta y publicaciones	2.5	3.2	3.0	3.2	3.4	0.2	0.2	6.7	6.2
28	Químicos y relacionados	4.9	16.4	16.9	17.5	18.0	0.6	0.5	3.6	2.9
29	Refinerías de petróleo y relacionados	2.6	2.6	1.6	1.5	1.4	-0.1	-0.1	-6.3	-6.7
30	Productos plásticos y de goma	4.2	4.5	5.0	4.6	4.8	-0.4	0.2	-8.0	4.3
31	Cuero y productos de cuero	8.9	6.0	5.3	5.6	5.4	0.3	-0.2	5.7	-3.6
32	Productos de piedra, barro y cristal	6.5	5.1	3.9	4.1	4.4	0.2	0.3	5.1	7.3
33	Productos primarios de metal	1.0	1.0	0.6	0.6	0.6	0.0	0.0	0.0	0.0
34	Productos fabricados de metal	4.5	4.7	3.7	3.6	3.7	-0.1	0.1	-2.7	2.8
35	Maquinaria, excepto eléctrica	1.3	6.9	7.6	5.9	5.5	-1.7	-0.4	-22.4	-6.8
36	Maquinaria y equipo eléctrico	9.9	17.6	22.5	21.4	20.0	-1.1	-1.4	-4.9	-6.5
37	Equipo de transportación	0.6	0.5	0.6	0.7	0.7	0.1	0.0	16.7	0.0
38	Instrumentos profesionales y									
39	Industrias manufactureras misceláneas	4.2	4.0	3.0	3.3	3.5	0.3	0.2	10.0	6.1

Fuente: Departamento del Trabajo y Recursos Humanos, Encuesta de Establecimientos; y Junta de Planificación, Area de Planificación Económica y Social, Negociado de Análisis Económico.

TABLE 4-7

DISTRIBUTION OF TAX BENEFITS AND EMPLOYMENT, BY INDUSTRY, 1983

	Percentage of tax benefits	Percentage of employees
All manufacturing industries	100%	100%
Food and kindred products	6.9	9.1
Textile mill products	0.2	1.1
Apparel	3.1	17.6
Chemicals	49.3	17.2
Pharmaceuticals	46.3	14.8
Other	3.0	2.6
Rubber and plastic products	0.7	1.3
Leather	1.0	5.3
Fabricated metal products	1.3	2.2
Machinery, except electrical	1.1	1.0
Electrical and electronic equipment	23.3	28.7
Instruments and related products	7.0	14.3
Other manufacturing	6.1	2.2

Department of the Treasury
Office of Tax Analysis

SOURCE: The amount of tax benefits is from Table 4-5, column 3. The number of employees is from Table 4-6, column 3.